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October 1, 1993

Mr. David L. Rauch
Executive Secretary
Missouri Public Service Commission
P. O. Box 360
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**RE: The Staff of the Missouri Public Service Commission v. Southwestern Bell Telephone Company, Case No. TC-93-224, et al.**

Dear Mr. Rauch:

Enclosed for filing in the above-captioned case is **STAFF'S REPLY BRIEF** which contains highly confidential information. We are filing the following:

8 complete non-proprietary sets
6 complete highly confidential sets
1 set highly confidential pages
1 set proprietary pages

This filing has been mailed or hand-delivered this date to all counsel of record.

Thank you for your attention to this matter.

Sincerely,

Robert J. Hack

Robert J. Hack
General Counsel
314-751-8705

FILED
OCT 1 1993
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## BEFORE THE PUBLIC SERVICE COMMISSION
## OF THE STATE OF MISSOURI

| | | |
|---|---|---|
| The Staff of the Missouri Public Service Commission,<br><br>Complainant,<br><br>vs.<br><br>Southwestern Bell Telephone Company, A Missouri corporation,<br><br>Respondent. | ) | Case No. TC-93-224, et al. |

FILED
OCT 7 1993
MISSOURI
PUBLIC SERVICE COMMISSION

# REPLY BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION

Submitted By:

Robert J. Hack
Thomas H. Luckenbill
Thomas R. Schwarz

October 1, 1993

**Denotes Proprietary Information**
**Denotes Highly Confidential Information**

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381.

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## I. INTRODUCTION

A close reading of Southwestern Bell Telephone Company's (SWBT or Company) initial brief in this matter reveals repeated self-contradictory and conflicting assertions. For example, at page 2 of its brief the Company characterizes the Staff recommendation[1] as a penalty for SWBT successfully "growing" earnings during the experiment, but by the time the reader reaches page 25 (and again at page 178) SWBT asserts that its profitability has declined during the experiment. Obviously both statements cannot be true. This is one reason that regulation of SWBT proves to be problematic. Statements which vary from issue to issue, seemingly dependent on whether SWBT believes one version or the other to be persuasive in an isolated context, make ascertainment of the truth difficult.

Throughout its initial brief, on a variety of issues, SWBT asserts that this Commission must decide certain issues one way or another in this case because of the manner in which the Part 32 issue was resolved in Case No. TC-89-14[2]. The Staff doubts that the Commission intended its Part 32 decision in Case No. TC-89-14 to have such effect. The Staff would be surprised if the Commission felt so bound in deciding this case. The Part 32 discussion in Case No. TC-89-14 revolved entirely around capital to expense shifts,

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[1]The Staff's case shows a negative revenue requirement of almost $150 million. (Staff Accounting Schedules, Ex. 215). The $135 million negative revenue requirement stated on page 181 of the Staff's initial brief is mistaken.

[2]Examples of such issues in this case include, but are not limited to: ST-TPUC (item II.8.), TEAM Annualization (item II.14.B.ii), Stock Plans (item II.14.F.), Compensated Absences (item II.14.J.), FAS 87 (item II.10.B.), FAS 106 (item II.10.C. ) and FAS 112 (item II.10.D.).

not accrual or GAAP accounting. Re Southwestern Bell, 607 Mo. P.S.C. (N.S.) 617-19 (1989). Perhaps if an issue of the magnitude of FAS 106 had been presented to the Commission in that case, the Part 32 issue would have been decided differently. The Staff acknowledges that the Report and Order in Case No. TC-89-14 contains some unfortunate language concerning ratemaking and Part 32. (Id. at 622). As an administrative agency, however, the Commission is not bound by the judicial concept of stare decisis. Moreover, blind acceptance by the Commission for ratemaking purposes of whatever Part 32 dictates that SWBT record for accounting purposes would be an abdication of the Commission's ultimate responsibility to fix just and reasonable rates.

SWBT apparently believes that regulation should exist only as a mechanism to raise rates and that regulators should be content if the Company does not request a rate increase. (SWBT Brief, pp. 1-3). Under such a scheme the Commission would ignore excessive earnings (as SWBT essentially requests in this case and for the future - See SWBT Brief, p. 196) but take action to protect the utility, at the utility's request, when earnings are deficient. Recalling its role as the balancer of ratepayer/shareholder interests, the Commission must definitively reject SWBT's asymmetrical notion.

SWBT's request that the Commission concentrate its focus on service price and quality is simply a disingenuous way to ask that excess earnings be ignored. The Staff agrees that service quality is important and should be monitored. The Staff also agrees that service price is important and should be examined. However, because effective competition for the vast majority of SWBT's services does not exist, one very important (and, the Staff submits, necessary) tool to use in assessing the reasonableness of service price is the Company's overall earnings level that can only be determined by traditional rate base/rate of return analysis. The applicable statutory standard also requires an earnings-based analysis. §§ 392.200.1 and 392.240.1 RSMo Supp. 1992[3]. Therefore, as indicated in the Staff's initial brief, the Commission must begin with an analysis of the sufficiency of SWBT's earnings.

The sheer multiplicity of revenue requirement issues for the Commission to resolve will make the earnings analysis difficult at best. Ironically, SWBT itself neglected to brief an issue born of one of its own proposed adjustments [Non-Wage - RTU (should be LTU) Fees] that is valued at nearly $2.6 million. (Ex. 244). The Commission should heed that example and take care to address each of the issues that has been presented. As the Commission deliberates, the Staff advises it to remember the chain of events that led to the implementation of the current experiment and keep in mind that it is best to bargain from a position of strength. Adoption of the Staff's positions would enable it to do so.

The Company argues that the only case properly before the Commission is its alternative regulatory framework (ARF) proposal because the Staff failed to obtain explicit Commission authority prior to filing the complaint which initiated Case No. TC-93-224. (SWBT Brief, pp. 3-4). Although a literal reading of § 386.390.1 in a vacuum would suggest that absent Commission authorization the Staff cannot prosecute a rate complaint, the Staff does not believe that such authority must necessarily antedate the filing of the complaint.

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[3]All statutory citations refer to RSMo Supp. 1992 unless specifically stated otherwise.

A reading of the Commission's rule on the subject (4 CSR 240-2.070) reveals no requirement that Commission authorization must precede the Staff's filing of a rate complaint. Had the Commission not desired to hear the complaint it certainly would not have established a procedural schedule and held hearings to which the parties have devoted a great deal of time, effort and money. That action amounts to implicit Commission ratification of the Staff's complaint filing. To remove any doubt about the question however, the Staff suggests that in its Report and Order the Commission expressly ratify the Staff's complaint filing to comply literally with the terms of § 386.240 RSMo 1986.

## II. REVENUE REQUIREMENT

### 1. Test Period Issues & Errors & Isolated Adjustments

Despite the Commission's clear admonition to the contrary, SWBT insistently attempts to use the update period as a mechanism to change the test year from December 31, 1991, to September 30, 1992. The Commission should be familiar with this ruse because St. Joseph Light & Power Company (SJLP) only recently tried to use it as a defense in Case No. EC-92-214. Although the Commission never issued a decision on the merits in that case, it decided SJLP's immediately succeeding rate case. In that case the Commission ruled, among other things, that the

> . . . [rate case] expenses incurred by SJLPC in Case No. EC-92-214 should be equally shared between SJLPC's ratepayers and shareholders and amortized over a two (2) year period. The Commission strongly supports a company's right to defend itself against a complaint initiated by Staff and, under normal circumstances, would allow the company to include the expense of its defense in the cost of service. However, the Commission finds that this rate complaint proceeding is different than other rate

> complaints or rate proceedings that have come before the Commission. The Commission points to SJLPC's insistence on filing its case on the wrong test year, which not only prolonged the hearing, but made it impossible to try the proceeding on an issue-by-issue basis. The Commission finds that the ratepayers should not be required to bear the entire burden of SJLPC's management decision to deliberately violate the Commission's test year order, thus unduly complicating and prolonging that case. Therefore, SJLPC's shareholders should bear part of the burden of this management decision. (Report and Order, Case Nos. ER-93-41 and EC-93-252, p. 16, issued June 25, 1993).

The Commission should likewise reject SWBT's attempt to shift the test year in this case.

If endorsed by the Commission, SWBT's position would transform the update period into a new test year. If that was the Commission's intention, then it likely would have ordered that the test year be the year ending September 30, 1992, and dropped any mention of an update period. By not doing so, the Commission recognized the obvious distinction between a test year and an update period. An update addresses legitimate regulatory concerns (i.e., lag) while still maintaining an appropriate balance between shareholders and ratepayers. The update was designed to pick up major capital investment (typically non-revenue producing) that comes into service after the end of the test year. In this case the update served the precise purpose for which it was intended by bringing into rate base the new St. Louis Data Center, an investment of roughly $150 million that came on line in May of 1992. The Commission should resist SWBT's attempts to abuse a legitimate regulatory device.

The Staff conducted a traditional update; it brought forward those items that are normally included in an update. As SWBT admits at page 6 of its initial brief, the Staff's update was substantial.

SWBT appears to be primarily concerned about a vague collection of items it denominates as non-wage expense.

SWBT's analysis (SWBT Brief, pp. 7-8) of revenue requirement elements is flawed because it assumes that revenues, expenses and rate base move in lockstep with one another. Although an important revenue/expense/rate base relationship exists, the notion that these elements relate to one another in a linear fashion (i.e., if one increases, they all increase) is absolutely untrue. SWBT's own brief and evidence bear this out. For example, SWBT concedes that it has access lines charged to plant in-service that exist to serve future customers (Crossley Surrebuttal, Ex. 76, p. 28); this increases rate base without causing a corresponding increase in revenues. Also, the new St. Louis Data Center (a massive investment) brought no corresponding revenue increase. Moreover, SWBT witness Keely testified that the installation of digital switching (which increased rate base) directly resulted in the elimination of 114 jobs (which reduced expenses) for SWBT-MO. (Keely Direct, Ex. 125, pp. 5-6). After asserting the lockstep revenue/expense/rate base relationship on pages 7 and 8 of its brief, in yet another example of inconsistency, SWBT alludes at page 13 of its brief to expense reductions during the course of the experiment even with expanding investment. Further, when the time came to defend its low level of revenues in its initial brief, SWBT failed to mention the fact that it will continue to add to rate base, as it has in the past, which will enable the offering of new services that will generate additional revenue. (SWBT Brief, pp. 169-173).

For all of the reasons expressed by the Staff, the Commission should reject SWBT's proposal to change the test year.

2. **Senate Bill No. 380, State Tax Increase**

On this issue SWBT argues only that its proposed adjustment should be adopted because it is known and measurable. First, as indicated in our initial brief, the Staff contends that the property tax portion of SB 380 is not known and measurable. (Tr. 204). More importantly, however, known and measurable is not the only standard SWBT's proposed adjustment must meet. SWBT failed to explain how its proposed isolated adjustment for an event occurring well beyond the end of both the test year and update period could be adopted without distorting an appropriate revenue/expense/rate base relationship. The reason for that failure is simple; it cannot be done. The Commission should reject SWBT's proposed adjustment.

3. **Rate Of Return**

A. Cost of Equity

SWBT's brief points out that the Staff has recommended higher return on equity (ROE) ranges for Orchard Farm Telephone Company, Citizens Telephone Company and United Telephone Company than the recommendation made for Southwestern Bell Telephone Company. The Staff analyzes the total business and financial risk of a utility in developing its recommended ROE. Although SWBT may face more competition than United, Orchard Farms, or Citizens due to its operations in Kansas City and St. Louis metropolitan markets, SWBT's overall business and financial risk (total risk) are less than the total risk of United, Citizens and Orchard Farms and, thus, should result in a lower required return. The Staff's recommended ROE for all of these telephone companies accounts for total risk as perceived by investors. The Staff's ROE recommendations are designed to fairly compensate investors based on the total perceived risk of the utility. A utility's embedded cost of long-term debt is a good comparison measure of total risk levels. SWBT's embedded cost of long-term debt is 8.18% while United Telephone Company's was determined to be 8.70%. This is one indication of the lower risk level of SWBT as compared to United.

i. Dr. Avera - Risk Premium and CAPM

Dr. Avera utilized several different risk premium methodologies to estimate a cost of equity for SWBT. Dr. Avera obtained results ranging from 11.62% up to 14.98% using these various methodologies. (Avera Rebuttal, Ex. 18, pp. 52-58). The wide variation in these ROE figures, in itself, shows the volatility of risk premium analyses which results depending upon the data utilized.

A fundamental basis underlying Dr. Avera's risk premium analyses is that there is an inverse relationship between interest rates and risk premiums. (Avera Rebuttal, Ex. 18, pp. 56-57).

There are numerous problems with Dr. Avera's analysis. First of all, the first study cited by Dr. Avera concluded that, at least for the period in which the study was performed, there was no relationship between interest rates and risk premiums. This puts into question Dr. Avera's statement that "There is no substantive dispute that equity risk premiums move inversely with interest rates." (Avera Rebuttal, Ex. 18, p. 49). Dr. Avera stated that most explanations for this inverse relationship parallel that articulated by Eugene F. Brigham, Phillip K. Shome and Steve R. Vinson in "The Risk Premium Approach to Measuring a Utility's Cost of Equity" Financial Management (Spring 1985):

> If the expected rate of inflation increases, then interest rates will increase and bond prices will fall. Thus, uncertainty about

> inflation translates directly into risks in the bond markets. The effect of inflation on stocks, including utility stocks, is less clear. If inflation increases, then utilities should, in theory, be able to obtain rate increases that would offset increases and operating costs and also compensate for the higher cost of equity. Thus, with "proper" regulation, utility stocks would provide a better hedge against unanticipated inflation than would bonds. (Id. at 51).

The above quote indicates the following: 1) an increase in inflation causes interest rates to increase; 2) interest rate increases cause bond prices to fall; 3) if inflation increases, utilities should be able to obtain rate increases to pay for increased operating costs and to compensate for the higher cost of equity.

The above quote may be interpreted to indicate a relationship between interest rates and cost of equity. The Staff certainly agrees that the cost of equity is influenced by interest rates. Thus, the reduction in long term interest rates of approximately 150 basis points since Case No. TC-89-14, et al., requires a significant reduction in the authorized return on equity of SWBT in this case.

A second flaw with regard to Dr. Avera's analysis is his claim that rates today are at such low levels that equity risk premiums should be at an all-time high (i.e., in the range of 7%). (Moore Surrebuttal, Ex. 14, p. 8). However, looking at the period of time from 1947 to 1992, one finds that current interest rates (particularly the long-term interest rates) are actually fairly close to the long term average and certainly cannot be characterized as being at an extraordinarily low level. Thus, there is no reason to conclude that current risk premiums are near an all-time high as Dr. Avera has suggested. (Id. at 8, ll. 11-20).

Finally, the third flaw with Dr. Avera's risk premium analyses is that the studies upon which he relies were performed exclusively on electric utilities, or a combination of utilities including many electric companies. Therefore, the relevance of the risk premiums computed thereby is open to question. (Id. at 8, ll. 21-23).

The Staff prepared two risk premium analyses. The results of the Staff's risk premium analyses were 10.54% (using 30 T-bonds) and 7.23% (using the three month T-bill) for SWBT ROE. This is a further indication of the great volatility associated with the risk premium approach.

The capital asset pricing model (CAPM) also suffers from volatility depending on the underlying data. The return on equity calculated by use of the CAPM depends on the average market return, the risk free rate of return and the factor beta. Each of these inputs will vary depending on the source of the data. Thus, an analyst can taylor the model to achieve the desired result. (Tr. 402-404).

SWBT states that:

> Dr. Avera estimated SWB's requirement ROE to be in the range of 12.77% to 13.77% under a properly conducted discounted cashflow (DCF) analysis, and in the range of 11.91% to 14.98% utilizing several forms of risk premium analysis.(SWBT Brief, p. 10).

Dr. Avera's entire rebuttal of Mr. Moore's DCF model and his "properly conducted" DCF analysis took a total of 18 lines of testimony. (Avera Rebuttal, Ex. 18, pp. 36-37). Dr. Avera criticizes Mr. Moore on the basis that Mr. Moore's projected growth rate for SBC is too low because it ignores the long-term growth potential of SBC's unregulated businesses. On the contrary, Mr. Moore considered recognized sources for projected growth rates for SBC. In addition, SBC's high dividend payout ratio in recent years is an inappropriate basis for calculating projected growth rates because over the long run, dividend growth will not exceed earnings growth. (Moore Surrebuttal, Ex. 14, p. 4). Dr. Avera's suggestion that the long-term growth rate projection should be elevated above 7.25% ,which is the high-end of Mr. Moore's growth rate range, lacks any reasonable basis.

In performing a DCF analysis, a self-respecting regulatory analyst cannot properly justify a high projected growth rate where the facts simply do not reasonably lead to that conclusion. Dr. Avera hangs his hat on the prospects of high returns to be earned by SBC's unregulated subsidiaries in the long-term. Sitting here today, no one knows how high or low the returns to be earned by SBC's unregulated subsidiaries will be. There is no basis in fact for Dr. Avera's conclusion that investors are demanding or expecting high returns from SBC. To the contrary, investors are more likely to see an investment in SBC's stock as a relatively low-risk alternative to bank CDs or money market funds. (Moore Surrebuttal, Ex. 14, p. 5). Looking to the historical earnings figures for SBC subsidiaries, one discovers that there are **________** unregulated subsidiaries which earned a return on common equity during 1991 in excess of the return on equity achieved by SWBT in 1991. Those unregulated subsidiaries are **________________________________________________

________________________________________________________________

________** which achieved a return on average equity of **______**.

As discussed in the Yellow Pages portion of this brief, SWBYP achieves extraordinary returns because of its relationship with SWBT.

Also, to date, the revenues of the Yellow Pages operation have been consolidated for purposes of ratemaking. Thus, advocating a high projected growth rate for SBC based on profits of SWBYP which will be consolidated in the ratemaking process anyway would be illogical.

SWBT states:

> . . . if [the Commission] elects to return to traditional regulation, the Commission may 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.

(SWBT Brief, pp. 12-13). This statement has many far reaching implications. First of all, it assumes that utilities must be induced to improve and invest in their utility operations by having the state regulatory commission increase authorized returns on equity. The record in this proceeding shows no relationship between Missouri construction and SWBT's authorized rate of return in Missouri. The Staff believes that the effect of granting SWBT a higher authorized ROE would merely be to enable SWBT to step up its merger and acquisition activities.

By way of a footnote, SWBT mentions its projected impact of the 1993 flood and the Omnibus Budget Reconciliation Act of 1993. These items are not in Staff's case because they are not test year items. Missouri uses a historical test year and has not used projected test years. The statements made at the hearing about the impact of the flood and other post-test year items are merely statements. The Staff has had no opportunity to audit or otherwise verify that information. It should be noted that SWBT has publicly stated that ratepayers would not be required to pay in rates for the damage caused by the flood.

SWBT argues that its return on equity should be increased even under traditional regulation to (a) encourage Missouri network investment; and (b) encourage a management efficiency. The Staff believes that there is no relationship between the authorized return on equity and investment by SWBT in its Missouri network. If a particular investment in the Missouri network is economic, SWBT will make the investment. A return on equity above a reasonable level would be a disservice to the utility ratepayers. With respect to managerial efficiency, regardless of the authorized return on equity, management efficiency will save dollars and the bottom line results will be improved.

SWBT suggests that long-term interest rates are going to increase to 8.3% over the next three years. (SWBT Brief, p. 14). Again, no one knows what long-term interest rates are going to do in the future. However, the Staff would note that on July 13, 1993, the treasury bond rate was at or around 6.65%. (Tr. 371).

The "study" performed by Mr. Orozco referenced in footnote 9 on page 16 of SWBT's initial brief which allegedly supports the statement that SBC is experiencing sufficient competition to require an increase in its required capital costs, is based on newspaper clippings, magazines and other items of general circulation. This is not competent evidence of meaningful competition upon which the Commission should base a decision to authorize SWBT to earn an extraordinarily high ROE.

SWBT suggests that "near term forecasts likely understated investor long-run expectations." (SWBT Brief, p. 21). The Staff disputes this statement. Rather, the converse is more likely to be true. Therefore, it is more logical to assume that a short-term growth projection could be extraordinarily high while the long-term growth rate is bound to have the tendency to move toward an average level of growth.

SWBT argues that the Commission should apply Dr. Avera's upward adjustment of 25 basis points for equity flotation costs. (SWBT Brief, pp. 21-22). SBC has not issued stock to raise capital since 1984. In addition, as stated by Mr. Moore in Surrebuttal Testimony, there is no evidence that SBC will be issuing common stock in the near future." (Moore Surrebuttal, Ex. 14, p. 6). There is simply no basis for an equity flotation cost adjustment. This would, if granted, constitute a fictional expense and improperly inflate SWBT's required ROE.

With regard to debt flotation costs, all of SBC's financing activity during the test year involved the refinancing of debt. No new debt was issued during the test year. In addition, during the four-year experiment, SWBT retained all savings from refinancings. (Martin Direct, Ex. 69, p. 26, Sch. 10).

SWBT notes that the Commission rejected a proposal which it considers similar to Dr. Johnson's proposal in Case No. TC-89-14. (SWBT Brief, p. 23). The Commission should seriously reconsider the argument for a downward adjustment reflecting the differential in risk characteristics between SWBT as compared to the other subsidiaries of SBC. The current structure of SBC gives more credence to this type of adjustment than the SBC structure which existed at the time of Case No. TC-89-14. Specifically, SBC has participated in mergers and acquisitions to the extent that a larger percent of SBC's consolidated assets are invested in non-SWBT assets.

The Report and Order issued in Case No. TC-89-14 stated that:

> . . . the regulated telephone operations of SWB comprise 87-89% of the parent corporation's assets and almost 96% of SBC's before-tax income. Re Southwestern Bell, 29 Mo. P.S.C. 605, 649 (1989).

Contrasted with that, as of December 31, 1991, SWBT's total assets accounted for 76% of SBC's consolidated total assets. Furthermore, SWBT accounts for approximately 80% of total operating revenues when compared to SBC's consolidated figures. (Moore Direct, Ex. 12, p. 15).

SWBT implies that Dr. Johnson's approach is similar to the approach used by the Staff and OPC to address risk differentials between SBC and SWBT in Case No. TC-89-14. (SWBT Brief, p. 23). SWBT's argument is misleading.

The Commission stated in Case No. TC-89-14:

> The major fault lies in Ileo's determination of a ROE for SWB based residually upon calculation of ROEs for SBC's unregulated subsidiaries. Re Southwestern Bell, 29 Mo. P.S.C. 605, 651 (1989).

However, Dr. Johnson's methodology is fundamentally different from and superior to the methodology rejected by the Commission in Case No. TC-89-14. Dr. Johnson's approach does not suffer from the "major fault" mentioned above. In fact, Dr. Johnson's approach is consistent with, but more detailed than the Commission's decision in Case No. TC-89-14. In that case, the Commission used the low end of Staff's recommended ROE range which was 35.5 basis points below the mid-point of Staff's recommended ROE range. As stated by Dr. Johnson:

> What I'm trying to do is take a portion of those

> higher risks that I believe is attributable to the unregulated operations, identify it separately, and make it feasible for the Commission to make an adjustment for that.
>
> In the prior case, that basic logic was looked at. The Commission chose to look at the lower end of the range. The impact of looking at the lower end of the range is fairly similar to the bottom line impact of what I'm doing.
>
> What I'm doing is more explicit and, I believe, somewhat more precise. And I believe it makes the calculations somewhat more susceptible to developing the evidence and reaching a final reasoned judgment, rather than simply saying, "Well, we know there's a problem; let's look at the low end of the range."

(Tr. 253-254).

SWBT strongly implies that Dr. Ben Johnson "presumed the cost of equity for SBC unregulated activities." (SWBT Brief, p. 24). The Staff takes exception with SWBT's characterization of the cost of equity for SBC unregulated activities as a "presumption." Dr. Johnson performed a thorough analysis of the return on average equity for subsidiaries of Southwestern Bell Corporation. (Johnson Direct, Ex. 10HC, HC Sch. 2). Dr. Johnson's analysis of the return on equity figures as well as other quantitative indicators form the basis of his conclusions and recommendation to the Commission. (Id. at 43-63).

Dr. Johnson found that "most of the other SBC subsidiaries have had widely fluctuating revenues, negative earnings, negative interest coverage, and inadequate internally generated cash flow." (Johnson Direct, Ex. 10HC, p. 56, ll. 27-30). Dr. Johnson concluded that the equity risks of SWBT versus the other SBC subsidiaries (with the exception of the Yellow Pages subsidiaries) "contrast like night and day." (Id. at p. 57, line 3). Dr. Johnson concluded that an appropriate analogy reflecting the great difference in risk between SWBT and the other SBC subsidiaries was the comparison of "Aa" bonds and "junk" bonds. (Id., p. 57, ll. 7-8). Therefore, it simply is not true that Dr. Johnson merely "presumed" a level of risk for SBC's unregulated activities.

SWBT asserts that Dr. Johnson erred 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. (SWBT Brief, p. 24). First, SWBT's assertion assumes that the risk characteristics of Telmex are identical to the risk characteristics of SWBT-Mo. Dr. Johnson has stated "from SBC's perspective, the business and political risks are higher for investment in a telephone company operating in Mexico than they are for investments in SWBT." (Johnson Surrebuttal, Ex. 11, p. 11, ll. 12-14). Second, SWBT witness Avera provided no calculations to demonstrate the effect of Telmex even assuming that Telmex has the same risk characteristics as SWBT-Missouri. (Id. at 11, ll. 2-8).

By giving SWBT every benefit of the doubt and assuming that Telmex is of an identical risk level as SWBT-Missouri and that Telmex constitutes 80% of the holdings of Southwestern Bell International holdings (a subsidiary of SBC), then the effect of treating Telmex as a regulated (less risky) venture, would be to reduce Dr. Johnson's adjustment to 40 basis points rather than 51 basis points. (Id. at 11-12). Therefore, Dr. Avera's statement that consideration of Telmex completely eliminates Dr. Johnson's adjustment is wrong.

With regard to footnote 17 on page 25 SWBT's brief, it is true that Staff witness Rucker conceded that decreases in Company revenues in certain service categories were likely due to competition.

However, overall revenues of SWBT are growing. The local service revenues of Southwestern Bell Telephone grew by approximately **___** million in 1991. (Rucker Surrebuttal, Ex. 28HC, Sch. 1).

It is irrefutable that SWBT's operations are far less risky than SBC's unregulated activities. In an effort to distract the Commission from this fundamental truth, SWBT devotes several pages of its brief to a variety of isolated and largely irrelevant matters, none of which substantially affect the need to make an appropriate adjustment for risk differences. (SWBT Brief, pp. 24-25). And, none of which have been demonstrated to have a significant effect upon the magnitude of such an adjustment. Accordingly, the Commission should adopt the Staff's recommendation to reduce SBC's cost of equity by 51 basis points for application to SWBT.

B. Cost of Debt

It is the Staff's position that SWBT's cost of short term and long term debt should be based on SBC's overall cost of debt on a consolidated basis as of September 30, 1992. Using SBC's consolidated figures, the cost of debt is 7.33%. (Moore Direct, Ex. 12, p. 18, Sch. 15). As pointed out in the Staff's initial brief, SBC and Southwestern Bell Capital Corporation (SBCC) are able to borrow funds at a low interest rate because of the credit strength derived from SWBT. (Staff Brief, p. 25).

C. Capital Structure

The Staff is recommending that the Commission use SBC's September 30, 1992, consolidated capital structure (55.65% equity, 36.41% long term debt, and 7.94% short term debt). (Moore Direct, Ex. 12, p. 17). SWBT recommends that the Commission use the actual September 30, 1992, capital structure of SWBT (57.42% equity and

42.58% debt).

As shown by the testimony and schedules filed in this case by Staff witnesses Johnson and Moore, the earnings of SWBT have shown far less variability than the earnings of other SBC subsidiaries. Financial theory would dictate that firms with higher earnings variability have higher financial risks and should have more equity on a percentage basis than firms with low earnings variability (low financial risk). Despite the inconsistency with financial theory and sound financial management, SWBT has a higher equity percentage (57.42%) than do the other subsidiary of SBC. As the Commission pointed out in Case No. TC-89-14:

> It is not logical for SWB to have a lower debt ratio than SBC when SWB is, in fact, less risky than SBC. . . . The dominance of SWB (Southwestern Bell Telephone Company) of SBC in all respects reenforces this decision. Since SWB is, in reality, SBC, it should get the benefit of SBC's capital structure. . . . [29 Mo. P.S.C. 605, 653 (1989)].

If SWBT's actual equity percentage is to be used by the Commission for ratemaking purpose, SBC will have an incentive to manipulate the equity percentage of SWBT.

4. <u>Depreciation</u>

The parties have discussed at length in their principal briefs the technical reasons for their respective positions. The Staff believed at the 1992 three-way meeting that SWBT's new depreciation methodologies were untenable, and nothing in Company's case or brief adds one iota of substance to those procedures. The Staff believes that the Commission would be well served to view the subject without the trappings of statistical pettifoggery. Common sense observations clearly demonstrate the speculative and unreliable nature of

Company's "analysis".

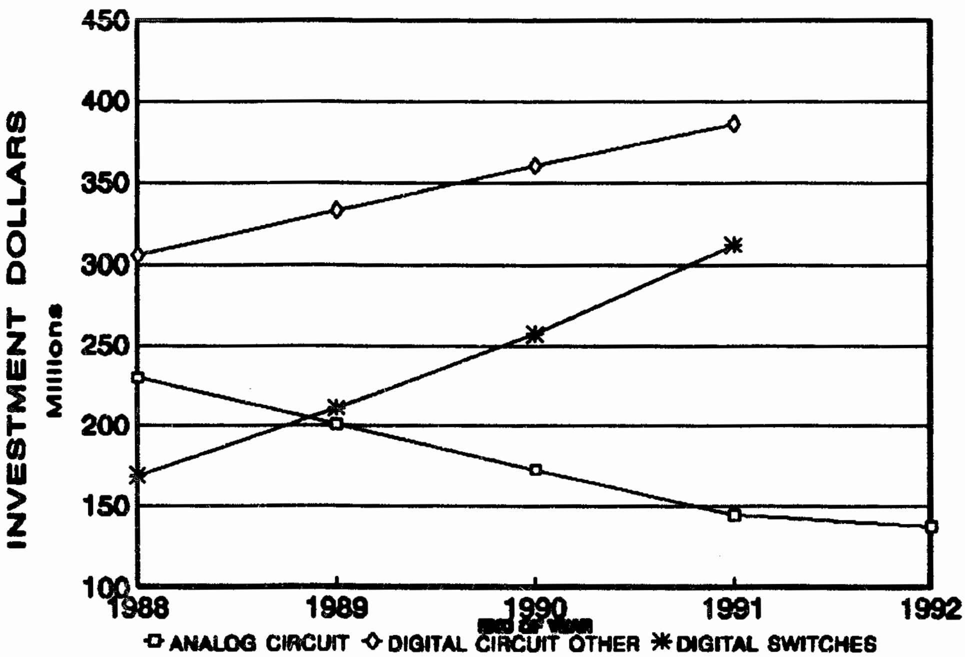
There are only two accounts in dispute in this case - Digital Switching (#2212), and Digital Circuit-Other (#2232). The Digital Circuit-Other account resulted from the 1986 division of the Circuit account into the Analog Circuit and the Digital Circuit-Other accounts. SWBT notes (SWBT Brief, p.34) that the two disputed accounts comprise nearly 20% of its depreciable property. Company fails to note that 28% of its Digital Circuit property has been added since 1988, and that its investment in the account continues to increase dramatically. More telling, the Company's investment in Digital Switching has increased 45.7% between 1988 and 1991.

Compare the investment history of these accounts with that of Analog Circuit account, upon whose depreciation parameters SWBT and the Staff agree. The Company's investment in this account shrank from $230,771,568 to $145,090,000 from 1988 through 1991. Company is proposing a remaining life for Digital Circuit which is but one year longer than the agreed-upon remaining life for Analog Circuit. The incredibility of this position is plainly demonstrated by the table and graph set out below. The Company's investment in the Analog Account was $145,090,000 and falling dramatically at the end of 1991, while its investment in the Digital Circuit Account was $408,784,000 and growing at year-end 1991. In the face of its own investment decisions, Company suggests no credible explanation why the remaining life of the Analog Account is only one year less than that of the Digital Account. Neither of the two disputed accounts appear to be threatened with imminent death, but rather, appear to be growing at a healthy pace. The Staff finds unreasonable Company's proposal to apply a remaining life estimate, suitable for a dying account, to a growing account.

The three accounts can be set out as follows:

**SOUTHWESTERN BELL TELEPHONE COMPANY**
**YEAR END INVESTMENT**
**MISSOURI**

| YEAR ENDING | ANALOG CIRCUIT | DIGITAL CIRCUIT OTHER | DIGITAL SWITCHES |
|---|---|---|---|
| 1988 | 230,771,568 | 294,464,294 | 169,465,194 |
| 1989 | 201,501,664 | 333,448,373 | 211,406,346 |
| 1990 | 172,531,564 | 372,279,120 | 256,906,749 |
| 1991 | 145,090,000 | 408,784,000 | 312,040,000 |
| 1992 | 138,417,529 | | |




| Remaining Life (in years) | | | |
|---|---|---|---|
| | Analog Circuit | Digital Circuit | Digital Switch |
| SWBT | 5.7 | 6.7 | 10.8 |
| The Staff | 5.7 | 8.5 | 12.7 |

The year end investment levels are obtained by subtracting retirements in year two from the ending balancef year one, and adding the additional investment made in year two.

Company has available to it the complete history of the property in the Digital Circuit- Other Account. More than 50% of this "new" account pre-dates the disaggregation of the Circuit Account in 1988. Company's failure to produce this evidence permits the inference that its production would indicate a longer life than Company asserts. Cooper v. Metropolitan Life Ins. Co., 94 S.W.2d 1070, 1072 Mo. App. 1936); Hall v. Missouri Pacific R.R. Co., 738 S.W.2d 595,596-597 (Mo. App. 1987).

Although braying of technical obsolescence and competitive threats, SWBT has not, and cannot, specify the newer technology which threatens digital with replacement in the immediate future. Even if the Company could specify the replacement technology, it has not specified when that technology will be economically viable for widespread installation. SWBT also fails to mention that software additions and upgrades can extend the life of the digital switch. This is, after all, a Company which only recently replaced its last Step-by-step and Crossbar technology, and then only at Commission direction and with ratepayers' moneys. It is simply not credible to assert that SWBT will replace digital switches with something else until it is assured of profitability. The Staff opposes overcharging current customers of SWBT for excessing depreciation based on unrealistically short lives.

SWBT chides the Staff for depreciation parameters and rates which are lower than those of other states. But, as the Staff has properly observed, there is nothing in Company's evidence to support the legitimacy of such comparisons, let alone provide the basis for an adjustment to Company's own, actual experience. Unaddressed by the Company's assertions are the customer mix, property mix, property age, regulatory climate, property types and brands, or reserve levels of even one of the "comparable" companies. Without such analysis, the comparisons are useless to the Staff or this Commission.

Company suggests that the Staff unreasonably ignores "more telling recent history" on the Digital Circuit Account. (SWBT Brief, p. 39). But examine that "data" a bit closer before judging its reliability. Company "generated" data by including one semi-annual observation in a chart with eleven annual observations. In its graphical representation (Exhibit 21, Sch. 6-1), the Company falsely scales this "data point" as an additional annual observation. While the nature of the datum is noted on the scale, its spatial misplacement makes the graph a visual misrepresentation.

Company makes much of the fact that actual retirements from the contested Accounts exceeded Company's forecasted retirements. (SWBT Brief, p. 38, p.40). Company's unidentified "experts" made the referenced forecasts in preparation for the three-way meeting in the spring of 1992. These forecasts looked 15-20 years into the future to predict the retirement of the last property from the Accounts with pinpoint accuracy, and thus specified retirements for the intervening periods. These predictions were made without the hindrance of having to rely on antiquated historical data. The results? The futurists missed the retirements mark within one year of the forecast by 27.5% in the Digital Circuit account, and by an unbelievable 863% in the Digital Switch account. The object of depreciation studies is accurate, not "conservative" or "liberal", estimates of property consumption. There is no reason to believe that the new-fangled methods used by SWBT produce good estimates, much less better ones than produced by the established, old-fangled methods employed by the Staff.

## 5. Compensable Property Depreciation Reserve

On this issue SWBT's arguments relate exclusively to method, completely ignoring results[4]. In so doing, SWBT elevates form over substance. The Commission is not bound to a single, formulaic methodology; its ultimate charge is to reach a just and reasonable result. State ex rel. Associated Natural Gas Co. v. PSC, 714 S.W.2d 870,880 (Mo. App. 1985). SWBT nowhere argues in this issue that application of a composite depreciation reserve in excess of 30% to One Bell Center (OBC) and the new St. Louis Data Center (Data Center), as the Company proposes, produces a reasonable result.

The Staff has not contested the Company's assertion that the Staff's methodology violates specific depreciation group accounting techniques (SWBT Brief, p. 42) because the point is irrelevant. The Staff agrees with SWBT that the property subject to the compensation study constitutes a relatively small portion of total Missouri property. (Id.). The Commission should ignore this red herring offered by SWBT however, and remember that OBC and the Data Center constitute more than 50% of the compensable property situated in Missouri. (Doerr Surrebuttal, Ex. 39, p. 3). So, in actuality, the compensable assets at issue - OBC and the Data Center - are quite large. That the Company is willing to stretch the imagination in order to prevail on an issue is shown by its tax code argument in

[4]SWBT's comments concerning the Staff's alterations are overblown. The only alteration Staff made on the stand was immaterial to a company of SWBT's size. (Tr. 606-607). Additionally, any inconsistencies on the Staff's part were not found to be material, a point the Staff made several times. (Tr. 605, 606, 608, 609, 610, 611).

this issue. (SWBT Brief, p. 42, footnote 26). Compensable Property is a plant allocation issue. SWBT's threat that the Staff's proposal regarding the proper allocation of compensable property to Missouri violates Internal Revenue Code normalization rules is simply wrong. The Internal Revenue Code does not dictate how this Commission may allocate general plant such as compensable property.

This issue exists for one reason alone. Because SWBT fails to record the depreciation reserve, deferred tax reserve and the related amortizations associated with assets that serve multiple states, these items can only be estimated. Given this lack of appropriate recordkeeping, it is no surprise that such estimates may vary[5]. SWBT's suggestion that this issue somehow results from the fault of the Staff (SWBT Brief, p. 43) is ludicrous. The uniqueness of this issue indicates that any reasonable multi-state utility (and Missouri has no shortage of utilities operating in more than one state) would keep the records necessary to isolate the depreciation reserve and deferred tax reserve associated with valuable assets that serve multiple jurisdictions.

Depreciation reserve is a rate base offset; it accounts for depreciation expense paid by ratepayers as a return of the Company's investment. Under SWBT's approach, a composite depreciation reserve of more than 30% would be applied to all compensable property, including OBC and the Data Center, in spite of the fact that OBC and

[5]SWBT indicates that the Staff's estimated OBC investment was in error. What SWBT refers to as "Mr. Richey's estimated 1991 OBC investment", was actually SWBT-provided and not consistent with what appeared in SWBT's compensation study. (Tr. 620-621). Also, the Staff found that averages were not used by SWBT to estimate the bulk of their compensable investment. (Doerr Surrebuttal, Ex. 39, p. 8).

the Data Center 1) comprise more than 50% of all compensable property in Missouri and 2) are not even close to 30% depreciated. (Doerr Direct, Ex. 38, p. 11). In so doing SWBT inappropriately increases the depreciation reserve allocated to states other than Missouri for depreciation expense paid by Missouri customers for assets serving Missouri, thereby inflating Missouri jurisdictional rate base.

6. St. Louis Data Center

SWBT employees moved into the Data Center from a number of locations other than 14 South 4th Street. (Tr. 641-42). Of all those facilities the only one SWBT alleges to have removed from cost of service is 14 South 4th Street. (Tr. 645). When asked the following question: "[A]re you proposing to remove those other buildings and associated expenses from cost of service?", SWBT witness Barfield testified, "No." [6](Tr. 642). SWBT's proposed Data Center adjustment therefore ignores appropriate offsets and is overstated. The Staff finds it incomprehensible for a decrease in total Missouri maintenance expenses by more than $3 million from 1991 to 1993 (which includes the 1993 maintenance expense for the Data Center) to have produced a need for any increase in maintenance expense for the Data Center. (Meyer Surrebuttal, Ex. 4, p. 24). However, if an increase is deemed appropriate, it should not exceed the difference in the total maintenance and property tax levels between the 1991 and 1993 compensation studies, $730,939 (or approximately $540,00 on an intrastate basis). (Id. at 24-25).

7. Interest During Construction (IDC)

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[6]There should have been no confusion on this point, mild or otherwise. As Mr. Barfield testified, the only building and expenses SWBT removed from cost of service was the old Data Center (14 South 4th Street).

IDC is intended to capture financing costs associated with plant under construction that is not included in rate base. (Tr. 536). The evidence shows that SWBT issues neither equity nor long-term debt to finance its construction program. (Riley Surrebuttal, Ex. 36, pp. 13-14). As a consequence, SWBT's assignment of its overall cost of capital (including the cost of equity and the cost of long-term debt) as IDC creates a fictional expense. The fact of the matter is that SWBT funds its construction projects with dollars obtained through depreciation expense and not from debt or equity issuances. In fact, under the Company's IDC methodology, construction funds in a given month that exceed that month's depreciation expense will be theoretically calculated at the short-term debt rate. (Toti Rebuttal, Ex. 37, p. 61). Calculating IDC at the short-term debt rate for the excess construction funds needed over depreciation expense in a given month is consistent with the Staff's method.

The Staff also opposes SWBT's IDC method because it results in customers paying a return on a return. This occurs because SWBT uses accumulated depreciation expense (paid by ratepayers) which reduces rate base (that is not immediately reflected in reduced rates for service) to fund construction (to which SWBT adds the overall cost of capital as the IDC rate). SWBT claims to have refuted this argument by pointing to a $200 million dollar rate base increase. (SWBT Brief, p. 47). This increase is unusual and is directly attributable to the addition of the new Data Center (an investment of about $150 million) in May of 1992; rate base actually declined from 1988 to 1989 and 1989 to 1990, started to increase in 1991 and did not exceed 1988 levels until 1992. (Tr. 578-79). The real trend that the Commission can expect to continue, therefore, is declining rate base.

SWBT's assertion (at page 47, footnote 37) that SWBT's shareholder (SBC) has been harmed as a result of this anomalous rate base increase is simply incredible. It should be noted that both the Company and the Staff have reflected the 1992 increase in rate base in each of its cost of service calculations. Because no party (including SWBT) has asserted that the Company's rates are anything but too high, SWBT's shareholder cannot have been deprived of anything to which it was entitled.

The historical IDC method is wrong. It compensates the Company for expenses that are not (and likely will not be) incurred and erroneously provides the Company a return on a return. The Commission should remedy this situation prospectively and adopt the Staff's proposed IDC methodology.

8. <u>Short-Term - Telephone Plant Under Construction (ST-TPUC)</u>

SWBT provides only cursory treatment of this issue in its initial brief (at pp. 49-50) and the Staff will respond in kind. First, if the issue is so small, why did SWBT pursue it against long-standing precedent? Second, in Case No. TC-89-14 the Commission did not adopt all of Part 32 for ratemaking purposes and the Commission should reject SWBT's self-serving assertions to the contrary[7]. Third, the fact that the test year ST-TPUC balance is in service does not mean customers actually receive a benefit from it. (Bailey Rebuttal, Ex. 91, p. 35). Fourth, the Staff believes the evidence

[7]At pages 30-31, footnote 18 of its initial brief SWBT argues that the unfavorable treatment of debt refinancing costs accorded by Part 32 justifies Commission authorization of a return range higher than that established by the Staff. Such contradictions (i.e., use Part 32 only when it increases revenue requirement) do little to bolster the reasonableness of the Company's presentation.

shows that central office upgrades provide additional net revenues, and so does the Company--on pages 37-38 and 178-79 of its initial brief. Fifth, footnote 41 at page 50 of SWBT's initial brief simply makes no sense (and also conflicts with statements made on page 177 of its initial brief). Why would SWBT make the investment necessary to upgrade central offices and offer new services if that investment provided no margin?

The Company's ST-TPUC proposal should be rejected.

9. <u>Cash Working Capital (CWC)</u>

The Staff does not dispute that CWC is a necessary cost of service component and for that reason has provided an allowance for CWC. The Staff must contest SWBT's assertion that "<u>[A]ll</u> investor supplied capital . . . must be recognized in the cost of service." (SWBT Brief, p. 50). Although seemingly axiomatic, it bears repeating here that investors are entitled to a return only on that investment which is prudent and used and useful in providing service. A corollary is that only expenses that are reasonable and necessary to provide service should be included in a utility's revenue requirement. Because the Staff considers SWBT's proposed 28.46 day collection lag (the period of time between SWBT's generation of the bill and its receipt of the customer's payment) excessive, imprudent, unreasonable and unnecessary, the Staff has recommended the use of a 21 day collection lag as a reasonable proxy. The Company's argument would lead the Commission to believe that all 2 million of SWBT's customers, on average, pay their bills late. This is wrong.

The Staff submits that the assessment of a nominal late payment charge, with the Commission's approval, against delinquent accounts (which by SWBT's own policy is after 10 and 21 days, respectively, for business and residential customers), would reduce SWBT's collection lag to a more reasonable level[8]. At a minimum, the late payment charge would help to offset the additional $1.5 million in annual costs associated with a collection lag of 28.46 days versus one of 21 days. The Commission's rule on late payment charges [4 CSR 240-33.040(5)] seems to allow this. Finally, because the imposition of a nominal, flat-fee late payment charge would simply require the insertion of a line item on the succeeding month's bill and not an entirely separate additional mailing, it would not cost $11 million on an annual basis. (SWBT Brief, p. 52, footnote 48). A late payment charge, therefore, would be cost effective.

The Commission should adopt the Staff's proposed collection lag of 21 days as it may motivate SWBT to improve its collection practices in such a manner as to achieve collection lags similar to other large utilities operating in Missouri.

10. Post Employment Benefits

A. Pensions (FAS 87)

Company again cites (SWBT Brief, p. 54-55) competition as a factor requiring Commission action, without specifying any detail. SWBT correctly notes that it has obtained Commission designation of certain services as transitionally competiitive, but fails to note that in the nine months since that order it has not filed a single tariff to meet the competitive challenge. Even more important, Company has not made any adjustment in this case for the FAS 87 costs to be borne by these transitionally competitive services.

SWBT mistakenly argues (SWBT Brief, pp. 57-58) that use of the

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[8]United Telephone Company has proposed to do so in its currently pending rate case. (Tr. 1821).

ERISA minimum can produce "wild swings in expense levels from year to year". In fact, by definition, the ERISA minimum cannot produce variations as great as FAS 87 because the FAS expense can be any integer (positive number, negative number or zero) while ERISA expense is limited to the range of positive integers or zero. The FAS 87 expense jumped $12,218,000 from 1989 to 1992, and more than $10 million from 1991 to 1992 alone. (Ex. 171) During that entire time the ERISA minimum pension expense fluctuated not one thin dime. Which method, then, appears the more volatile?

From its citation to the Appendix in its brief, it is not clear that Company has read the document. First, the date of the document is February, 1992, and not "earlier this year" as Company suggests (SWBT Brief, p. 59). Second, the order is the New York Commission's solicitation of comments from the utility industry and the public upon its Staff's proposals, and not an adoption of an accounting methodology as Company seems to suggest. Third, the material quoted at length by SWBT at pages 59 and 62 of its brief are the proposals of the New York Staff, and not of the New York Commission. Finally, the rationale given by the New York Staff (at pages 4 to 6 of Appendix A to the N.Y.Commission's order) for favoring FAS 87 (e.g. possible subjectivity of pension fund earnings actuarial estimates) are not persuasive.

The Staff concurs that this Commission cannot confiscate the property of any regulated utility. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 64 S.Ct. 281 (1944). But there is no evidence to indicate that anything like confiscation of property is about to befall SWBT. Company's sample calculations (SWBT Brief, pp. 61-63) have no basis in reality, much less in the record of this case. The question presented by this issue is one of timing only, and not of ultimate recovery of pension costs. If this Commission permits SWBT to recover its ERISA minimum funding requirements the Company will recover sufficient funds to timely meet its obligations. (Traxler Surrebuttal, Ex. 161, p. 5).

Company misstates the facts when it alleges that adoption of SFAS 87 by this Commission in Case TC-89-14 resulted in a $19,000,000 per year reduction in customer rates. The rates set as a result of Case TC-89-14 resulted not from a contested case decision of this Commission, but of a settled figure some $20,000,000 above the revenue requirement found in the Report and Order of that case. The Company's present rates can be laid at the feet of any number of major issues in that case, and there is no legitimacy whatsoever in attributing the final rates to any particular element of the case.

The provisions of FAS 87 do come into play through the alternative regulation plan approved in Case TO-90-1, which has resulted in SWBT customers receiving the benefit of pension credits recorded from July 1, 1989, through December 31, 1991. In fact, the SWBT pension expense for 1992 was positive. (Traxler Surrebuttal, Ex. 161, p. 10). Since the booked pension expense is the amount used in determining credits under the current alternative regulation plan, ratepayers could not have benefited from a negative pension credit for 1992. In summary, Company's assertion that ratepayers have benefited $19 million a year since 1989 from a reduction of rates as a result of a pension credit used in determining pension cost in Case TC-89-14 is false, because pension cost under the sharing plan has been based upon SWBT's <u>actual</u> <u>booked</u> pension expense since 1990. (Tr. pp. 1625-26; Ex. 165).

Furthermore, no write-off of the Company's prepaid pension asset will be necessary if this Commission adopts ERISA minimum funding for pension expense. The reversal of the Company's prepaid pension asset began in 1992 when the pension expense reflected on Company's books under FAS 87 turned positive by $1,700,00. (Ex. 171). Because the current alternate regulation experiment will be in effect until January 1, 1994, SWBT will have recovered the increase in FAS 87 pension expense occurring in 1992 and 1993. The reversal was accelerated by the credit to the prepaid pension asset created by SWBT's 401(h) transfer of pension assets to pay for OPEB expense. (Tr. pp. 1650-1651). The Company's actuary estimates that the prepaid pension asset will have completely reversed itself by January 1, 1995. (Traxler Surrebuttal, Ex. 161, p. 9-11).

The Staff renews its recommendation to the Commission that it adopt the ERISA minimum funding requirement of SWBT, which embodies accrual accounting principles, in determining Company's revenue requirement. Company's arguments for continued use of FAS 87 for pension expense calculation are, by comparison, insubstantial and unpersuasive.

B. OPEBs (FAS 106)

SWBT contends on the one hand that whether or not it has a legal obligation to provide OPEBs is merely a matter of semantics (SWBT Brief, p. 80); then admits that such legal obligation as it has is for five years only and is imposed by federal pension and tax law, and not by contract with its employees. (SWBT Brief, p. 81). The existence, or not, of a legal obligation is much more than a semantic nicety. If a legal obligation exists, current and future retirees can obtain judicial enforcement of rights against Company's property;

if no legal obligation exists, they cannot. This has real world implications of which the Company is well aware. (SWBT Brief, p. 61).

Furthermore, Company's admission that its legal liability is for five years only calls into question the need for a 30 year projection of costs to measure it. Company's current pay-as-you-go amount is likely to serve quite nicely as an estimate of expenses only five years into the future.

Company conveniently takes two positions on its history of health care costs. At pages 71 and 72 of its brief, Company argues that its effective efforts, jointly pursued with the Communication Workers of America, "should be viewed as a positive factor qualifying the Company for FAS 106 recovery." However, at page 77 of its brief SWBT objects to the Staff's observation that Company's actuary used a health care cost trend rate (HCCTR) in computing FAS 106 OPEB expense which at all times is considerably higher than Company's actual recent experience and the actuararies' own projection. Exhibit 173 plainly demonstrates that once the Company's benefit cap is reached Company's health care costs trend rate will be flat because no further increase in Company's outlays will be required. SWBT's references to the increases in health care costs to be borne by its retirees and the public in general are neither relevant nor material to the issue of what it will cost SWBT to provide the capped benefits. They only serve to distract attention from appropriate analysis.

SWBT admits, if only implicitly, that it cannot fully fund its FAS 106 OPEB expense. First, despite challenge at hearing (Tr., pp. 1637-1638) Company has cited no provision of the Internal Revenue

Code which would permit funding of FAS 106 OPEB expense for its non-collectively bargained employees. This is further borne out by the Company's carefully chosen language: "thus a tax advantaged vehicle is currently available to fully fund the annual expense level for several year". (SWBT Brief, p. 73). This language acknowledges that, once SWBT's Collectively Bargained VEBA is funded, there is no tax-advantaged funding mechanism for its FAS 106 OPEB expense.

The Commission should also note that the Company did not make an adjustment for FAS 106 expense when such an adjustment would reduce its revenues. Company's adjustment to its regulated expenses for its proposed deregulation of the Kansas City Data Center is based on 1991 figures. SWBT's proposed reduction to expense, therefore, cannot and does not reflect the decrease to regulated expense caused by the shift of a portion of FAS 106 expense to the Kansas City Data Center operations. Also, it is not clear that the FAS 106 actuarial calculation includes employee reductions, which the Company vigorously maintains will be ongoing. (SWBT Brief, pp. 107-108).

Finally, Company acknowledges that the OPEBs issue involves a recording, not a recovery, issue. (SWBT Brief, p. 86). Although the Company does so in the context of its write-off of the $2 billion FAS 106 transition benefit obligation (TBO), SWBT's observation is equally true of the entire FAS 106/OPEB issue as Staff has contended all along. That is, Company is entitled to recover from ratepayers the monies it prudently expends on reasonably incurred benefits (including retiree OPEBs) for its employees. Staff has not, and does not now, contend otherwise. Using pay as you go for ratemaking insures that the Company recovers its full costs <u>and</u> that ratepayers provide the funds to do so only if and when needed.

On page 64 of its brief, SWBT states that it seeks FAS 106 treatment of OPEBs which will put it "on an equal footing with unregulated competitors." Presumably, then, the alleged competitors' handling of FAS 106, including use of an immediate write-off of the TBO rather than an extended amortization, might have some relevance to SWBT's implementation of FAS 106. Mirabile dictu, on the question of a TBO write-off, SWBT asserts that "investors and bankers" will compare SWBT to other regulated utilities in regard to recovery of the TBO (SWBT Brief, p. 86), and implicitly asserts that immediate write-off of the TBO by non-regulated competitors is not relevant. In short, SWBT's position appears to be that reliance on "competition" as a factor to justify FAS 106 ratemaking is only appropriate to the extent that it supports recovery of maximum amounts of OPEB costs from current and future ratepayers.

Company has the burden of persuasion on this issue. (Tr. 1475). Nothing in Company's brief or the record of this case establishes that there is a better estimate of SWBT's OPEB expense than its test year expenditure under the pay-as-you-go approach.

C. Other Post Employment Benefits (FAS 112)

The Staff will not reply to SWBT's brief on the issue of FAS 112, other than to reiterate its observation that the FAS 112 Transition Obligation is a non-recurring item ill-suited to inclusion in rates.

11. Deregulated Services

By its proposed deregulated services adjustment SWBT suggests that it will incur less deregulated costs on a going forward basis. This suggestion is nonsense. It conflicts with the Company's positions on Compensable Property (item II.5 - where SWBT argues that the new Data Center will bring about increased maintenance expenses, the Kansas City Data Center (item II.17 - which SWBT argues should be treated as non-regulated operation beginning January 1, 1993) and Non-Wage Expense - End-of-Period (item II.21.B.1 - where the Company argues that all non-wage expenses are increasing). Fixing cost of service on the basis of such inconsistent positions will undoubtedly result in overly compensatory rates for SWBT.

This issue epitomizes why the Staff's position on the test year and update period is appropriate and should be adopted. The Staff audited the documents associated with the 1991 cost allocation manual (CAM) changes (including external auditor workpapers). In his rebuttal testimony, SWBT witness Doherty failed to explain the basis of the 1992 CAM changes asserted by SWBT. (Doherty Rebuttal, Ex. 32). The Staff foolishly believed that it would receive the 1992 external auditor workpapers in a timely manner. As of June 14, 1993 (the surrebuttal testimony filing date), SWBT had not provided to the Staff the external auditor workpapers associated with the 1992 CAM changes asserted by SWBT. (Schallenberg Surrebuttal, Ex. 31, p. 23). As noted in the Staff's motion to compel filed herein on July 15, 1993, when the 1992 external auditor workpapers finally were provided, they actually showed deregulated costs to be greater in 1992 than in 1991.

The Commission should therefore adopt the adjustment proposed by the Staff for deregulated services.

12. Separations

The Staff has not contested whether this adjustment proposed by SWBT for an event occurring beyond the end of the test year and update period is known and measurable. The analysis does not conclude here, however. As with its position on Senate Bill No. 380 (item II.2), SWBT ignores the requirement that adjustments for post-test year and post-update period events must take into account potential offsets so as not to distort an appropriate revenue/expense/rate base relationship. Because the Company's proposal addresses but a single March 1993 separations factor change and does not address other potentially offsetting separations factor changes, its adoption will distort an appropriate revenue/expense/rate base relationship. The Commission should therefore reject this proposed isolated adjustment.

13. Right To Use License Fees (Shown on second page of the reconciliation as the "Non-Wage-RTU Fees" sub-issue under "Non-Wage Test Period")[9].

SWBT goes to some lengths in its initial brief to explain the withdrawal of its position on an issue that no longer exists (RTU Fee Amortization) and, ironically, neglects to argue its position on the related issue that, in the Staff's opinion, continues to exist (Non-Wage-LTU Fees). If SWBT cannot even remember to brief an issue, it certainly had no business taking it to hearing. Because SWBT did not address Non-Wage-LTU Fees in its initial brief, the Staff cannot respond here. The Staff should therefore prevail on the issue of Non-Wage-LTU Fees.

The Staff is also compelled at this point to explain the failings of SWBT's explanation of the withdrawal of its position on the RTU Fee Amortization issue. The Staff never indicated to SWBT that it would oppose inclusion of all RTU fees in the 1992 credit

[9]As explained in its initial btrief, this issue more closely relates to License-To-Use (LTU) fees than Right-To-Use (RTU) fees.

calculation. The terms of the experiment require early identification and resolution of issues so that customer credits are not unduly delayed. (Goldammer Direct, Ex. 93, Sch. 1-61). The Staff certainly would have made its opposition known prior to May 3, 1993 (the rebuttal testimony filing date). Furthermore, although OPC indicated its lack of opposition on May 14, 1993, (SWBT Brief, pp. 93-94), SWBT did not withdraw its position on the 1992 RTU Fee Amortization until July 14, 1993, the day before the issue was scheduled to be heard. (Tr. 521). Finally, the reason SWBT asserts as justifying the withdrawal of its position on the RTU Fee Amortization (inclusion and full recovery in the 1992 credit calculation) also applies to SWBT's position on the Enhanced Management Pension (EMP) and Enhanced Pension (EP) issue (item II.14.E) which has not been withdrawn. (Schallenberg Surrebuttal, Ex. 31, P. 11).

14. <u>Employee Compensation</u>

A. Senior Management Incentives

It can be reasonable for ratepayers to bear the cost of management incentive plans if such plans focus on the regulated operations and services provided to those paying the price tag. The nexus between the incentive plan and ratepayer benefit must be reasonably proximate, however, and the cost of incentive plans that may actually be detrimental to ratepayers must not be included in cost of service.

The primary problem with SWBT's senior management incentive plans is that they are based upon SBC results instead of SWBT operating results or, better yet, SWBT's Missouri regulated results. Conditioning incentives on SBC performance is contrary to regulatory interests because it tends to elevate deregulated and non-SWBT activities over SWBT performance. The Staff submits that the SBC Parent Costs and Affiliated Transactions issues (items II.15 and II.16) in this case provide numerous examples of deregulated and non-SWBT interests taking precedence over those of SWBT. Because the incentives SWBT offers to its senior management play a role in elevating deregulated and non-SWBT activities, SWBT ratepayers should not bear the cost of such plans.

At page 96 of its initial brief SWBT indicates that its short-term incentive plan is designed to improve performance. As stated by the Company itself at pages 25 and 178 of its initial brief, however, SWBT's profitability declined from 1990 to 1991 and again from 1991 to 1992. Performance obviously did not improve, therefore no bonuses are deserved.

The Staff agrees that the long-term incentive plan may cause SWBT managers to take action in the present that is intended to have long-term results. SWBT demonstrates this farsightedness in a number of issues in this case, although the Staff asserts that the beneficiary of that long-term focus is SWBT or, more likely, SBC, than SWBT's Missouri ratepayers. The long-term objectives of the Company's senior management can be discerned in SWBT's positions on Yellow Pages, flotation costs and FAS 106, among other issues. The Company's position on Yellow Pages is perhaps the most obvious example because it relates to and so closely parallels the manner by which it spun the Yellow Pages operations out of the telephone company and into a separate subsidiary. When it sought to spin out Yellow Pages, SWBT claimed that it would have no impact on the ability of the Commission to use Yellow Pages results in the rate setting process. (Featherstone Direct, Ex. 200, Sch. 6-12, and 6-29 through 31). Now, this separation forms an important part of SWBT's argument that Yellow Pages results do not relate to the provision of telephone service and therefore should not be included in SWBT's cost of service calculation. (D. Robertson Direct, Ex. 48, pp. 22-24). SWBT's proposal in this case to reduce its earnings sharing grid by 340 basis points in exchange for not including Yellow Pages results in the revenue requirement is similarly forward looking. Even though SWBT claims that adoption of its proposal will not impair the Commission's ability to include Yellow Pages results when setting rates in the future (SWBT Brief, p. 158), one cannot doubt that SWBT would use the Commission's adoption of its proposal as another effective component in support of its attempts (both regulatory and legislative) to completely sever Yellow Pages and telephone company results. The Company's positions on FAS 106 and flotation costs also reveal an eye towards long-term strategy and goals. While it may be true that long-term senior management incentives may not be the sole cause of such positions, the Staff believes that they may enhance the resolve of the Company to re-try issues such as flotation costs, inflation adjustment, ST-TPUC, Business Meals and COR/Salvage for Pre-1981 Property that have been lost under similar circumstances so many times in the past[10].

At page 100 of its initial brief, SWBT implies that adoption of the Staff's proposed adjustment for senior management incentives will

[10]For example, on flotation costs, Re Kansas City Power & Light, 75 P.U.R. 4th 1, 21 (Mo. P.S.C. 1986); Re Union Electric, 90 P.U.R. 4th 400, 422 (Mo. P.S.C. 1987); and Re Southwestern Bell, 104 P.U.R. 4th 381, 426 (Mo. P.S.C. 1989). Cases on the other issues are cited in the Staff's initial brief.

lead to higher base salaries and no incentive payments. First, SWBT has made no showing that its base salaries alone -- without addition of the so-called performance-based incentives -- constitute an insufficient compensation package. Second, if SWBT's incentive compensation is truly performance - based, then SWBT's declining profitability from 1990 to 1991 and again from 1991 to 1992 (SWBT Brief, pp. 25 and 178) should preclude the award of such compensation to SWBT's senior management in Missouri. The fact that SBC stock prices have increased despite this drop in SWBT-MO's profitability may indicate, among other things, that SWBT-MO is not a substantial part of SBC's total operations, that SWBT's declining profitability may be the result of affiliate transactions that bolster the overall profitability of SBC or even that SWBT has manipulated its earnings. The Commission should adopt this adjustment proposed by the Staff as it did in Case No. TC-89-14. Re Southwestern Bell, 29 Mo. P.S.C. (N.S.) 607, 626-27 (1989).

B. Team Effectiveness Award For Managers (TEAM)

i. GHQ/Services TEAM Awards

The Staff's proposal to disallow the cost of TEAM awards made to SWBT's GHQ/Services employees is based largely on the same principles as its senior management incentives adjustment. SWBT harps on the fact that the TEAM awards are a part of the total compensation package which, allegedly, is not excessive. By looking at Exhibit 55P the Commission can reach its own conclusions as to whether SWBT overly compensates its employees. The Staff submits that no evidence has been adduced that would indicate that SWBT's base compensation (without bonuses) is deficient in any respect.

The Commission has stated that:

> [A]t a minimum, an acceptable management performance plan should contain goals that improve existing performance, and the benefits of the plan should be ascertainable and reasonably related to the incentive plan.

Re Union Electric, 29 Mo. P.S.C. (N.S.) 313, 325 (1987). The Commission made that pronouncement nearly six years ago and the Staff asserts that it should hold true today. At pages 25 and 178 of its initial brief SWBT states that its earnings performance has declined annually since 1990. If the GHQ/Services TEAM awards are actually performance-based, then these faltering performance results indicate that no bonuses are deserved. Because GHQ/Services TEAM awards are based on the performance of SWBT's five-state area and not only that of SWBT-MO, the irrational result could occur (as it has here) where bonuses are awarded despite performance slippages. This is not an acceptable incentive plan and ratepayers should not be required to fund it.

ii. TEAM Annualization

At pages 103-104 of its initial brief SWBT once again indicates that the Commission's decision on Part 32 in Case No. TC-89-14 controls the outcome of an item not addressed by the Commission in its discussion of Part 32[11]. It cannot be credibly argued that the Part 32 decision in Case No. TC-89-14 even remotely relates to the TEAM annualization issue presented here.

[11]In this instance, following Part 32 and GAAP accounting for ratemaking purposes increases revenue requirement. At page 30, footnote 18 of its initial brief, SWBT asks for a higher authorized return because in that particular issue, Part 32 accounting decreases revenue requirement. Additionally, at page 86 of its initial brief, SWBT alleges that the FAS 106 TBO write-off allowed by GAAP is simply a recording, and not a recovery issue. These inconsistencies may all be matters of principle to SWBT, but the Staff cannot yet identify which principle that might be.

The Staff has used the most recent TEAM award payments, adjusted for EMP retirees, which should be reasonably representative of these costs on a going forward basis. Given SWBT's recent announcement of additional impending management work force reductions, the Staff has quite likely overstated TEAM expenses in its cost of service calculation.

C. Expense Percentage

This is a technical accounting issue concerning three clearing accounts and the applicability of these accounts in the calculation of an expense percentage. One of the clearing accounts the Company included in its calculation is the custom work order (CWO) account.

At page 104 of its initial brief, SWBT indicates CWO is a continuing activity and thus, CWO charges should be included in the expense percentage calculation. This is both misleading and incorrect. It is irrelevant what level of costs are charged to the CWO account on an annual basis. Account balances for CWO and the other clearing accounts are not included in the Company's financial statements. (Tunks Surrebuttal, Ex. 176, p. 22). Therefore, such non-operating items (that are neither expensed nor capitalized) should be omitted from the expense percentage. The Company clearly did not use the proper data in its calculation.

Further, SWBT incorrectly states at page 105 of its initial brief that the Staff used 1991 data which allegedly understates the expense percentage. The Staff's calculation appropriately updated all information needed to September 30, 1992. Further, the Staff has not understated the expense percentage at all; rather, the Company has overstated its calculation by including the balances of non-operating clearing accounts and the CWO account.

An expense percentage is to be applied to an annualized cost for purposes of determining the proper expense to include in cost of service for setting rates. (Tunks Direct, Ex. 175, p. 9). The Commission should reject SWBT's method which factors the wrong components into the expense percentage calculation.

D. Severance Payment Plans

This issue concerns expenses for work force reductions that SWBT has negotiated with its labor unions. The Staff's proposal to exclude such costs from the calculation of SWBT's revenue requirement is based on the simple and undisputed fact that an employee cannot receive both severance pay and regular compensation at the same time. If the severance payments exceeded regular compensation, SWBT employees would rarely, if ever, be laid off. SWBT does in fact lay off employees with some regularity.

At page 82 of its initial brief SWBT states that a certain level of trust is a reality in the regulated arena. The Staff agrees. The Staff has fixed payroll costs by reference to employee levels existing as of September 30, 1992. (Tunks Direct, Ex. 175, pp. 7-8). It is a fact that some of these employees will be laid off, generating savings for the Company that exceed the associated severance payments. It is just plain wrong to include in cost of service both the salary of an employee that will be laid off and severance payments that will be made to that ex-employee. Either, but only one, of these items may properly be included in cost of service; the Staff has included the more expensive of the two. The Commission can trust that the Staff's position is less likely to result in overly compensatory rates.

At page 106 of its initial brief SWBT asserts that both current and future customers benefit from the reduced wage expense produced by severance payment costs. This statement would be true only if SWBT's rates were reduced automatically as wage expense savings are generated. As the Commission should be well aware, this does not happen; SWBT vigorously resists attempts to reduce its rates.

Footnote 87 on page 106 of SWBT's initial brief illustrates the philosophical chasm between the Staff and the Company on this issue. If 1991 or 1992 severance payments are to be included in cost of service, the Commission should remove from cost of service those employees existing on the payroll as of September 30, 1992, who may be laid off under the terms of the severance payment plan. Obviously, the number and identity of such employees is unknown. Likewise, quantification of the adjustment necessary to prevent double recovery would be unmeasurable. The Staff's approach is simple, sure, fair and should be adopted by the Commission as it was in Case No. TC-89-14. Re Southwestern Bell, 607 Mo. P.S.C. (N.S.) 625 (1989).

E. Enhanced Management Pension (EMP) and Enhanced Pension (EP)

SWBT initially claims that EP- and EMP-type work force reduction plans are recurring in nature and thus should properly be included in cost of service. (SWBT Brief, p. 107). Incongruously however, SWBT then proposes to amortize these costs over three years. (SWBT Brief, p. 108). Typically, costs for extraordinary events are amortized; costs for recurring expenses are not. SWBT's proposal is internally inconsistent.

More importantly, though, SWBT's amortization proposal should be rejected because the Company has already recovered all of its EP and EMP expenses -- they were fully reflected and accounted for in the 1992 credit calculation, when no customer credits were issued under the experiment. (Schallenberg Surrebuttal, Ex. 31, p. 11). SWBT does not deny this fact but simply attempts to diminish its importance. (SWBT Brief, p. 109). SWBT should have withdrawn its EP/EMP amortization proposal for the same reasons it withdrew its RTU Fee amortization proposal. (See SWBT Brief, pp. 93-94).

The Commission should reject SWBT's attempts to liken the costs of work force reduction plans to the costs associated with replacing old plant with new and more efficient technology. (SWBT Brief, p. 109). The situations are not analogous. Although plant in rate base accrues depreciation and earns a return, the associated costs are not fully recovered in one year; all of SWBT's rate base was not expensed in 1992. But in this issue, all EP and EMP expenses were paid for when incurred and were therefore fully recovered in 1992.

SWBT's proposal to recover work force reduction costs should be rejected on a more conceptual basis as well. Identical to the analysis regarding the cost of severance payment plans (item II.14.D., supra), an ongoing level of work force reduction costs should not be included in cost of service unless the future payroll savings (i.e,., the salaries of laid off employees) to be generated by those plans is included also.

The Staff prevailed on an identical issue (Management Transitional Program) in Case No. TC-89-14. Re Southwestern Bell, 607 Mo. P.S.C. (N.S.) 624-25 (1989). For all of these reasons, the Commission should adopt the Staff's proposed adjustment for EP and EMP costs.

F. Stock Plans

Once again, SWBT wields the Commission's Part 32 decision in Case No. TC-89-14 like a shotgun, seemingly claiming authority to include in rates any half-baked accrual it can cook up. As explained in the introductory portion of this brief (Section I), the applicability of the Commission's Part 32 decision in Case No. TC-89-14 is not nearly as broad as SWBT's interpretation suggests. In fact, Part 32 itself provides for an account the purpose of which is to book variances from Part 32 created by regulatory decisions. 47 CFR § 32.1500 (1992).

SWBT did not implement these stock appreciation plans until late in 1992, thus the annual costs of these plans will not be known until sometime in 1993. Even if such costs are now known and measurable, SWBT's failure to also incorporate potentially offsetting revenue increases or expense decreases occurring subsequent to the update period distorts an appropriate revenue/expense/rate base relationship. If it is true that SWBT-MO employees can take actions which directly increase SBC stock prices (which, upon a reading of pages 84-85 of SWBT's initial brief, is a notion that SWBT itself does not wholeheartedly believe), then these stock appreciation plans should have a downward impact on SWBT's required ROE, another potential offset that SWBT's adjustment ignores. Moreover, tying SWBT employees' compensation to SBC's stock price may actually be detrimental to SWBT ratepayers. (<u>See</u> item II.14.A. supra).

G. Other Payroll Issues

The TEAM award and senior management incentive updates are addressed in item II.14.B.ii. SWBT's proposed isolated adjustment for the March 1, 1993, management salary increase is addressed in item II.14.I.

H. Yellow Pages Payroll Adjustment

The Staff adequately addressed this issue in its initial brief.

I. March 1, 1993, Management Salary Increase

The Staff continues to oppose SWBT's proposed adjustment to increase revenue requirement for management salary increases that took effect on March 1, 1993, on the grounds that its adoption will distort an appropriate revenue/expense/rate base relationship. (Schallenberg Surrebuttal, Ex. 31, pp. 21-22). Although it may be true that this salary hike will not directly cause additional revenues (SWBT Brief, p. 112), other items exist that may potentially offset this expense increase. First, even SWBT admits that revenues are increasing; that increasing revenues are not directly caused by the management salary increases does not preclude using them as a potential offset. Second, at pages 107-108 of its initial brief, SWBT indicates that its management force will continue to be reduced in the future. If true, the resulting expense savings are another potential offset. Moreover, if management force reductions do continue (and SWBT has publicly stated that they will), then SWBT has overstated its adjustment by applying the March 1, 1993, salary increase to the level of management employees existing as of September 30, 1992, which level is being reduced on a going forward basis. This factual situation renders inapposite the cases SWBT has cited as supporting its proposed adjustment (Re St. Louis County Water and Re Citizens Electric).

The Commission should reject this isolated adjustment proposed by SWBT.

J. Compensated Absences

This is a recording issue, not a recovery issue. SWBT has not disputed the Staff's assertion that the costs SWBT seeks to recover here <u>will not be paid</u> unless the Company goes out of business. (SWBT Brief, pp. 113-115; Wepfer Cross-Surrebuttal, Ex. 44). This exposes one of the major fallacies of using accrual accounting to set rates: it allows to be recorded as current expenses items that will not be paid. Accrual profits cannot be used to pay bills or stave off bankruptcy because they are no more than paper entries. Similarly, rates should not be based upon accrued expenses that, in this particular instance, represent fictional costs. Compounding the unfairness of its proposal is SWBT's attempt to deny ratepayers the benefit of the tax deduction corresponding to this item should the Commission decide to include this "expense" in SWBT's cost of service (see item II.18.A)[12].

Yet again the Commission is confronted with an argument by SWBT that the Part 32 decision in Case No. TC-89-14 dictates the resolution of an issue in this case. The Staff searched the Commission's discussion of Part 32 in Case No. TC-89-14 in an attempt to find any references to either accrual accounting or compensated absences. These efforts were in vain, however, as they disclosed no such references.

The Commission should therefore reject SWBT's proposal to recover "expenses" that will not be paid.

15. <u>Southwestern Bell Corporation (SBC) Parent Costs</u>

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[12]If the Commission appropriately excludes these fictional expenses from cost of service, there will be no corresponding tax deduction and the Vacation Pay sub-issue of Income Taxes disappears.

### A. Business Unit Adjustment

The Staff's business unit approach to cost allocation is based on the benefits subsidiaries receive in the form of discounted costs. (Schallenberg Direct, Ex. 29, pp. 15-18; and Supp. Surrebuttal, Ex. 218, pp. 47-79). SWBT witness Flaherty's literature search revealed that determination of benefit is consistently applied to ascertain an appropriate allocation. (Flaherty Rebuttal, Ex. 219, p. 8). Therefore, contrary to the Company's assertion (SWBT Brief, p. 115), the Staff's business unit approach clearly must enjoy support in both industry practice and accounting theory.

SWBT alleges that the Staff's application of the business unit approach inappropriately groups subsidiaries that are engaged in entirely unrelated lines of business. (SWBT Brief, p. 115). This is absurd. In fact, in the cost of capital issue (SWBT Brief, p. 24) the Company claimed that SWBT and TelMex are comparable because both are regulated. SBC is a telecommunications enterprise; all of its subsidiaries engage in business related to the telecommunications field. (See Moore Direct, Ex. 12, pp. 12-14). That is why the Staff's Bellcore analogy is appropriate. (Schallenberg Supp. Surrebuttal, Ex. 218, pp. 14). Moreover, if each subsidiary engages in businesses truly unrelated to the others (which the Staff disputes), then perhaps the Staff should have made each subsidiary a business unit for allocation purposes, which would have resulted in eleven business units rather than the four proposed by the Staff. Had the Staff done so, more costs would have been allocated away from SWBT. The Staff has therefore conservatively applied the business unit approach.

SWBT's arguments comparing the percentage of employees to the percentage of employee-related costs might be persuasive if one assumed that SBC provides all employee-related items to all of its subsidiaries. This assumption is not true. That SWBT performs its own employee-related tasks is shown by the fact that its non-consultant payroll witnesses in this case (Barbour and Smith) are SWBT rather than SBC employees. (Barbour Rebuttal, ex. 182, p. 1; Smith Rebuttal, Ex. 183, p. 1). SWBT has no need for SBC to perform its employee-related tasks. The SBC subsidiaries other than SWBT, however, are too small to perform these employee-related tasks for themselves and therefore benefit the most from SBC's ability to spread among several entities the fixed costs of performing employee-related functions.

In conclusion, it bears repeating that the cost centers SWBT allocates by use of the employee and investment factors include costs that are neither caused by nor bear any direct or indirect relationship to either the number of employees or the dollars of equity investment.

The Commission should adopt the Staff's business unit approach as a more rational and equitable basis of allocating costs.

### B. SBC General Factor Adjustment And Inclusion Of SBC In The General Factor

The Company asserts that as a parent company SBC performs functions (and therefore incurs costs) solely because of the existence and for the benefit of its subsidiaries. (SWBT Brief, p. 116). Therefore, according to SWBT, SBC should not be treated as a business unit and none of its retained expenses should be included in the calculation of the general allocation factor. (SWBT Brief, pp. 116-117). This is wrong. The evidence shows that SBC performs functions separate and distinct from the relations it has as a parent with its subsidiaries.

First, SBC undertakes merger and acquisition (M&A) activities. (SWBT Response To Staff Motion To Compel, filed June 14, 1993, pp. 7-12). These M&A functions of SBC are not caused by the existence of its subsidiaries. Moreover, SBC's M&A activity provides no benefit to its subsidiaries; the benefit of such activities inures solely to SBC.

Second, if SBC performs functions <u>solely</u> on behalf of and for the benefit of its operating subsidiaries, then there would be no reason for SBC to retain any costs. In fact, SBC retains (i.e., directly assigns to itself) costs. (Flaherty Schedule 2, Ex. 220, p. V-17).

Third, according to SWBT witness Flaherty's employer, Deloitte & Touche, SBC was created ". . . to provide for the strategic and financial management of the activities of its existing and future group of operating subsidiaries. . . ." (Schallenberg Supp. Surrebuttal, Ex. 218, p. 10, ll. 6-8). The job description for SBC's Managing Director-Strategic planning includes the following statement:

> Southwestern Bell Corporation is a holding company formed for economic and legal reasons as a result of divestiture from AT&T. As an independent business entity, SBC is solely responsible for the development and implementation of its strategic plan which is the basis for corporate return and growth involving not only existing subsidiaries but also the acquisition and development of new lines of business that capitalize on the strength of the overall corporation. (<u>Id.</u> at 10-11).

Clearly, SBC exists to do more than serve its corporate subsidiaries.

The truth is that SBC has functions which are independent of its subsidiaries. SBC may be likened to a large institutional investor. It could exist, have a purpose and perform functions as a mutual fund or a pension fund even without its subsidiaries. It is these functions which SBC currently performs that justify treating SBC as a business unit as the Staff has proposed.

The Company also suggests that SBC is little more than a cost center. (SWBT Brief, p. 117). That statement is not correct. No SBC subsidiary would have purchased Telmex; it took SBC's ability to extract dollars from the subsidiaries (which could otherwise have paid dividends to shareholders) in order to amass the capital necessary to purchase TelMex. All of the subsidiaries' earnings go to SBC. This is why the equity balance of SWBT has not changed since divestiture. SBC maintains large cash reserves (which is equity) and decides whether to invest those funds in existing subsidiaries or to acquire other businesses. If SBC was not truly a profit center (as opposed to a cost center as alleged by SWBT) it would not have possessed the wherewithal to purchase TelMex.

In the last paragraph on page 117 of its initial brief SWBT confuses directly assigned expenses with generally allocated expenses. If direct charging (which equates to retaining) expenses to an entity precludes the allocation of costs to that entity, as SWBT appears to argue, then no costs should be allocated to SWBT (because costs are direct charged to SWBT). This makes no sense and contravenes the following express language used by the FCC to describe the allocation of general costs:

> When neither direct nor indirect measures of cost causation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities. (Schallenberg Supp. Surrebuttal, Ex. 218, p. 5). (Emphasis supplied).

The foregoing language also demonstrates that footnote 94 on page 117 of SWBT's initial brief is wrong and should be ignored.

On page 118 of its initial brief SWBT exposes the tenuousness of its own position by threatening to manipulate CAM results if the Commission adopts the Staff's position. The Staff believes that SWBT has violated its CAM in this case; threats to do so again in the future (by refusing to directly assign costs to SBC) are not particularly impressive.

SWBT concludes this section of its brief by arguing that the allocation process should be the same among its six jurisdictions (five states plus the FCC) or the potential for over- or under-recovery is created. The reader may get the false impression that no jurisdiction has disallowed costs flowing from SBC's cost allocation process. Both Texas and Oklahoma have adjusted SBC's cost allocations[13].

C. SBC Expense Disallowances

i. Executive And Board Of Directors

The Staff agrees that speculation and conjecture do not qualify as substantial or competent evidence. SWBT misses the mark by a wide margin, however, in characterizing the Staff's evidence on SBC

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[13] Re Southwestern Bell, 137 P.U.R. 4th 63, 116-118 (OCC 1992); Re Southwestern Bell, 74 P.U.R. 4th 624, 677-78 (OCC 1986); Re Southwestern Bell, Docket Nos. 8585, 8218, Examiners' Report (Tex. P.U.C. November 29, 1990), Case Abstract published at 131 P.U.R. 4th 131.

allocations as mere speculation and conjecture (SWBT Brief, pp. 118-19) or conclusory and unsubstantiated allegations (SWBT Brief, p. 26, footnote 99). Ironically, SWBT itself admits that the Staff uncovered ten separate instances of improper or unreasonable allocations; this is a part of the Staff's evidence. (SWBT Brief, p. 126, footnote 99; and Appendix C). SWBT's reliance on the tactic of mischaracterizing the Staff's evidence instead of defending its allocation practices belies the weakness of SBC's allocation methodology. As the Commission considers the reasonableness, necessity and duplication of SBC functions charged to SWBT, it should keep in mind the hierarchical relationship between SBC and SWBT--SWBT being the subordinate--and that very few, if any, of these transactions can honestly be called "arms length" deals.

In defending the bloated costs caused by two boards of directors (SBC and SWBT), the Company shows exactly how unnecessary the SBC board of directors is to SWBT. To paraphrase, the SBC board sets policy and strategy for the entire corporation, while the SWBT board runs the telephone company. (SWBT Brief, p. 119). Since the functions of the two boards are different, according to SWBT, no duplication has occurred and the associated costs are necessary. The Commission should reject this specious argument. Missouri ratepayers should pay for a board of directors that runs the telephone company[14]; they have no need for another board of directors that dictates M&A strategy and policy for a multi-national corporation. The Staff has included the board of director and executive costs

[14]The Staff recognizes that two outside directors are legally required and agrees that reasonable costs associated therewith are necessary and should be included in cost of service. (Schallenberg Supp. Surrebuttal, Ex. 218, p. 27).

associated with those executives (the SWBT board and executives) who perform necessary telephone company functions. (SWBT Brief, p. 120). The Staff has excluded the others.

Footnote 96 on page 119 of SWBT's initial brief provides another example of unnecessary and duplicative costs. Both SWBT and SBC file 10-Q and 10-K forms with the SEC. The Staff agrees that SWBT ratepayers should bear the cost of preparing and filing one 10-Q and one 10-K annually, which is all that SWBT itself is required to file. SWBT's ratepayers should not also be required to fund a portion of SBC's 10-Q and 10-K filings. The allocation of such costs to SWBT is clearly associated with an unnecessary and duplicative function.

On page 121 of its initial brief, the Company claims that SWBT benefits from SBC setting compensation and benefit standards for the entire corporation on a centralized basis. SWBT has no need for commonality of compensation and benefits packages between itself and the other subsidiaries. This commonality allows for employee movement among subsidiaries primarily to the benefit of SBC and the subsidiaries other than SWBT. The SBC board of directors works to obtain commonality among its subsidiaries because such commonality is required for the board to exert effective control over the subsidiaries (i.e., it would be difficult even to <u>know</u> eleven different compensation and benefit packages, let alone manage them). The expense needed to obtain commonality is not typical of a stand-alone business -- for example, SWBT compensation packages need not be compatible with those of McDonnell-Douglas or Monsanto -- and is another reason why costs should be assigned to SBC through use of the general allocator.

In addition to being irrelevant, footnote 98 on page 121 of

SWBT's initial brief is wrong. Mr. Flaherty's cost estimates result from flawed analyses and are not reliable. (Schallenberg Supp. Surrebuttal, Ex. 218, pp. 53-55). There is no question that costs will increase if the centralized functions performed by SBC are moved to Missouri. The Staff also has no doubt that SBC has the ability to incur more costs than it does presently. But neither of those analyses asks (much less answers) the true question: would costs decrease by having SWBT in its entirety (all five states) perform the centralized functions currently undertaken by SBC?

SWBT is correct that the FCC rules do not require SBC board members and executives to keep time sheets. However, SWBT's CAM requires the direct assignment of all costs possible. (Riley Direct, Ex. 35, p. 6). By not keeping time sheets (or some other tracking mechanism), costs that should be directly assigned are understated.

ii. Other SBC Expense Disallowances

The Staff has included in its case costs in the SWBT employee information cost center the function of which, as SWBT describes it, is to provide ". . . information that is specifically related to issues and concerns of telephone company employees." (SWBT Brief, p. 122). The Staff excluded costs in the SBC employee information cost center the function of which, according to SWBT, is to provide ". . . 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." (Id.). The Staff therefore allowed all necessary costs (i.e., those that relate to the telephone company).

The SBC employee publication cost center is allocated on the employee factor. If the Company's assertion that the non-telco articles in SWBT'S "This Week" are simply drawn from SBC publications such as "SBC Fax" (SWBT Brief, p. 123), then SBC should charge SWBT for only one copy of such publications. The allocation of more than 85% the costs in the SBC employee publication cost center to SWBT which results from SBC's use of the employee factor is clearly excessive. (Schallenberg Direct, Ex. 29, Sch. 4-22).

SWBT pre-existed SBC and the rest of the SBC subsidiaries by decades. Thus, to the extent that the Southwestern Bell trademark and logo have value, that value was established by SWBT. Consequently, the primary beneficiaries of the name and logo are the non-telco SBC subsidiaries and SBC itself, none of which existed prior to 1984. SWBT has no name recognition problem and thus derives no benefit from the SBC trademarks, patents and graphic service cost center. The Staff has therefore excluded the costs for those functions from SWBT's cost of service.

To support the necessity of the SBC tax group, the Company claims that SBC's assistance saved SWBT over $50 million in taxes in 1992. (SWBT Brief, p. 125). The Staff has seen no evidence of this. SWBT's tax witnesses do not mention it in their testimony (Exhibits 37 and 227), nor has SWBT included a $50 million tax adjustment in its case. Further, the record does not disclose whether these alleged tax savings have been stated by the Company on a SWBT-MO or SWBT-wide basis[15].

SWBT maintains its own lines of credit and has no need for SBC

[15]The Staff suspects they have been stated on a SWBT-wide basis. The manner in which the Company switches perspective (between Missouri only and all of SWBT) in order to make the numbers appear impressive is interesting. (See SWBT Brief, p. 121, footnote 98).

to provide it with more. The line of credit provided by SBC is not "free" as alleged by SWBT because SBC allocates costs in the cash management cost center to SWBT. Another function of the SBC cash management cost center is to invest SWBT's surplus cash on SWBT's behalf. (Flaherty Rebuttal, Ex. 219, p. 51). The problem with allocating costs to SWBT for this function, as the Company admits, is that SWBT is rarely, if ever, in a surplus cash position. (Id.; and SWBT Brief, p. 49, footnote 40).

16. Affiliate Transactions

Perusal of SWBT's initial brief strongly reinforces the Staff's expressed concerns about the lack of effective and systematic control to prevent cross-subsidization by SWBT of its corporate affiliates at ratepayer expense. The issue is far more important than the Staff's $2.72 million adjustment in a $150 million case indicates. Indeed, if this Commission does not insist the that Company reform its recordkeeping in this area, it may never have a clear picture of the nature and extent of cross-subsidization at SWBT. Space does not permit a point by point rejoinder to SWBT's brief. The Staff's failure to address any particular points should not be read as a concession of merit to those points.

Company concedes (SWBT brief, p. 127) that transactions between a regulated utility and its corporate affiliates are the subject of particular scrutiny because of the potential for abuse by cross-subsidization. "Throughout the United States it is recognized that a public utility's dealings with affiliates require thorough investigation and close scrutiny by a public utility commission." Turpen v. Oklahoma Corporation Commission, 769 P.2d 1309, 1320 (Okl.

1988).[16]

The nature of the affiliate transaction problem at SWBT is illustrated precisely by footnote 102 at p. 128 of Company's brief. There, Company acknowledges that this Commission has the authority to disallow improper affiliate transactions. Company implies that this power of the Commission is a disincentive to cross-subsidization, but in reality it is a disincentive to being <u>caught</u>. The core problems with the affiliate transaction issue in this case have been caused by the Company's failure, whether by design or otherwise, to effectively and systematically structure its transactions with affiliates to avoid cross-subsidization, and to provide a meaningful audit trail of those transactions. This failure is the reason that the Company has produced reams of disjointed and unsatisfactory records in response to Staff Data Requests; it is the reason that so relatively few of SWBT's affiliate transactions were reviewed; it is the reason that there is an appearance of an anecdotal approach looking for "gotchas". If SWBT's attitude toward, and recording of its affiliate transactions does not change, the sad state of affairs reflected in this record will repeat itself in the future.

SWBT cannot establish a proper audit for its affiliate transactions because it does not gather and review the necessary information at the time it engages in those transactions. Specifically, SWBT does not inquire into the relevant market prices for services which it purchases from and sells to affiliates. Two examples must suffice for this reply brief.

The first glaring example is contained in the testimony of SWBT

[16]The Oklahoma Supreme Court cites seven federal and state appellate decisions as authority in a footnote to this quotation.

witness Morse (Tr. 2186-2198). In the awarding of a multi-million dollar contract, Mr. Morse is unaware of contracts for services obtained by other members of the industry, and sees no reason to expend resources in doing an RFP and evaluations. He relies on the fact that no other publishers have sought to sell him services as confirmation of his perspective. The Staff suggests that this is not the attitude of a hard-nosed competitor. Another example is the one noted in the Staff's initial brief at page 102, concerning SWBT's transactions with its affiliate, The Hotel Majestic. In that regard, it is important to note that The Hotel Majestic transaction apparently passed the Company's purchased compliance reviews. (Larkin Rebuttal, Ex. 222, Sch. 3-1; Sch. 10-1).

That such examples can be found should not be surprising. The form designed and used to control and monitor SWBT's affiliate transactions does not attempt to capture relevant market information. That form, SW-1161 (Larkin Rebuttal, Ex. 222, Sch.2), indicates that Company limits its inquiry to costs despite this Commission's admonition in its report and order in TC-89-14 that "SWB's failure to use market information and to document its pricing criteria makes prices paid by affiliates to SWB suspect." Re Southwestern Bell, 29 Mo. P.S.C. (N.S.) 607, 657. Until SWBT gathers, records, and retains market confirmation of the reasonableness of its affiliated transactions, it will not have an appropriate audit trail comporting with this Commission's just expectations.

In its brief SWBT attempts to avoid responsibility with such comments that TAI has "confus[ed] volume with complexity" and that "an audit trail exists, but TAI has not chosen . . . to follow it." (Tr., p. 129) As with all rhetoric, one must look further to find true meaning. Consider in this regard Mr. Lundy's statement as to why he viewed TAI's probing for an "audit trail" in discovery as being excessive and impractical:

> . . . backup data to cost studies normally consists of some authoritative source for inputs to the study. It does not, and should not normally include all the details as to how each source was developed. We accept numbers from company reports, for example, but it would be clearly impractical for a cost analyst to become an expert on the detailed development of each company report. (Ex. 241, p. 31)

Now we see the true meaning of SWBT's comments in its brief. Specifically, if an "audit trail" does exist within SWBT, no one who responded to TAI's discovery was aware of its existence despite designation as Subject Matter Experts. Furthermore, when employees are offered by a firm as being authoritative on an internal process or procedure, but nevertheless possess insufficient knowledge regarding that process or procedure, an "audit trail" is necessarily non-existent.

The Staff's $2.72 million revenue requirement adjustment related to affiliated transactions is based on its review of SWBT sales of services to its affiliates. One example must suffice to underscore the historical problems with SWBT's affiliate transactions in this regard. It also highlights why SWBT's rebuttal testimony is unpersuasive, as well as why SWBT's brief tells an incomplete story.

The TAI report concluded that the absence of a loading for supervision costs in many of the FDC studies performed by SWBT relating to services sold to affiliates was improper. (Ex. 229P, pp. 45-50). Even though he was neither responsible for providing FDC studies in response to discovery nor involved in performing such studies, Mr. Lundy's rebuttal attempted to rationalize the absence of a provision for supervision costs in many of SWBT's FDC studies. The essence of Mr. Lundy's remarks is that a supervision cost loading is always made by SWBT except either when supervision is provided by the affiliate to which the SWBT employee is loaned or when the SWBT supervisor is directly involved in rendering services to affiliates. (Lundy Rebuttal, Ex. 241, pp. 6-10)

In his surrebuttal testimony, Dr. Ileo refuted Mr. Lundy's first rationalization with a number of showings, including the observation that some supervision cost loading is always necessary because a SWBT "supervisor of a SWBT loaned employee would still be required to handle grievances and other problems, complete employee evaluation reports, and conduct other supervisory duties." (Ileo Surrebuttal, Ex. 237, p. 16).

With respect to his second rationalization, Mr. Lundy claimed that he found only one instance of a supervision cost problem in the 281 FDC studies he purported to review. (Lundy Rebuttal, Ex. 241, pp. 6-7) However, Dr. Ileo showed that even upon accepting Mr. Lundy's second rationalization, a supervision cost problem was found in two (2) of just the 11 FDC studies provided by SWBT in discovery and considered in the TAI report. This is an error rate of nearly 20% (2/11), far more consequential than the faulty impression (1/281) created by Mr. Lundy's erroneous determination. (Ileo Surrebuttal, Ex. 237, p. 17)

How is it that Mr. Lundy only found one error in 281 FDC studies when two documented errors are exhibited in just the 11 FDC studies made available to TAI? SWBT's brief fails to reconcile this inconsistency.

The evidence in this case leads to the inescapable conclusion that the Commission must act to protect Missouri ratepayers against SWBT's affiliate transactions. In the first instance, this means that the Commission should adopt Staff's $2.72 million revenue adjustment with the recognition that it likely represents the "tip of the iceberg." Second, and perhaps more important, the Commission should institute the structural and procedural safeguards recommended by the Staff.

17. <u>Kansas City Data Center</u>

On page 90 of its initial brief SWBT agreed with the Staff that the CAM should be used to remove non-regulated service results from cost of service. SWBT asserts that the Kansas City Data Center (KCDC) should be treated as non-regulated commencing January 1, 1993, and removed from cost of service. SWBT did not use its CAM to remove the results of KCDC operations from cost of service, however. In fact, SWBT cannot know the impact of its re-classification of the KCDC as non-regulated until after 1993 because until then, SWBT's CAM will not reflect a full year's worth of KCDC non-regulated operations. It is a fact that the allocation of all residual cost pools to deregulated services will increase[17], but the magnitude of that increase is presently unknown. If the Commission adopts SWBT's position on this issue, it can be assured that the adjustment SWBT has proposed for FAS 106 is overstated because it is based on 1991 data when the KCDC was a regulated operation. (Schallenberg Surrebuttal, Ex. 31, pp. 23-24).

The Commission should reject the adjustment proposed by SWBT

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[17]SWBT's position on this issue conflicts with its position on deregulated services (item II.11), where it argues that deregulated costs will be lower on a going forward basis.

related to the KCDC.

## 18. Income Taxes

Despite the claims of SWBT witness Flaherty that the SBC tax department saved SWBT $50 million in income taxes in 1992, the Company apparently still believes that it needs a greater amount of ratepayer dollars to fund its income tax obligations on a going forward basis.

### A. Vacation Pay

On page 149 of its initial brief SWBT acknowledges that the vacation pay tax deduction (associated with the ten year amortization) was created by the adoption of Part 32 which, for SWBT, became effective July 1, 1989. The Staff agrees. SWBT wrongly implies that the Commission's order to flow through vacation costs in Case No. TR-79-213 somehow related to the normalization treatment of such costs that the Commission ordered in Case No. TC-89-14. The book/tax timing difference that existed at the time the Commission decided case No. TR-79-213 was eliminated by the 1987 Revenue Act[18]. Consequently, between that time and the adoption of Part 32 for SWBT (July 1, 1989), there was no book/tax timing difference that could have been flowed through to customers. In fact, SWBT has not disputed the Staff's assertion that the tax deduction associated with the ten year amortization for compensated absences was <u>not</u> flowed through to the benefit of the ratepayers in Case No. TC-89-14. The Commission should therefore remedy this situation prospectively by giving the ratepayers the benefit of the tax deduction associated

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[18]SWBT's discussion of whether the book/tax timing difference for vacation pay was eliminated by the 1986 Tax Reform Act or the 1987 Revenue Act adds very little to the resolution of this issue.

with expenses they fund for compensated absences[19].

B.&C. Amortization of Investment Tax Credit (ITC) And Excess Deferred Income Taxes (EDIT)

As with the compensable property issue (item II.5), this issue exists because SWBT fails to keep the records needed to show that EDIT and ITC exist for the property in question. The difficulty is that ITC and EDIT may be associated with some of the property but SWBT has no records to show which property or how much ITC and EDIT are related thereto. Clearly there is no ITC associated with the new St. Louis Data Center because it came into existence after the ITC was repealed. (Meyer Surrebuttal, Ex. 4, p. 20). SWBT's proposal incorrectly attributes ITC to the new ST. Louis Data Center. In an attempt to give some recognition for ITC and EDIT the Staff included $100,000 ($50,000 for each item) in its case. (Tr. 2326). The Commission should not reward SWBT's recordkeeping failures by adopting the Company's proposal which increases its revenue requirement.

D. Cost of Removal/Salvage For Pre-1981 Property

(i) Expense

The Company incorrectly described this issue in its initial brief. This issue revolves around choosing the correct balance associated with Cost of Removal/Salvage for Pre-1981 Property. The Staff included the December 31, 1991, level because of concerns it had with the September 30, 1992, level. The September 30, 1992,

[19]The Staff has not included this tax deduction in its case because it believes the costs SWBT seeks to recover for compensated absences are fictional. (<u>See</u> item II.14.J. <u>supra</u>). If the Commission allows this as an item of expense, however, the tax deduction must be provided. If the Commission appropriately disallows this "expense", then the tax deduction issue disappears.

balance revealed that salvage was greater than cost of removal. This condition is abnormal and the Company has provided no explanation for it. The abnormality may have occurred simply because of a booking error. Therefore, the Staff used the December 31, 1991, balance as more reasonable since that balance reflects that cost of removal is greater than salvage. The Staff believes that historically this same condition has existed. The Staff's position reflects the conditions that are more reasonably to be expected in the future. Thus, it should be adopted by the Commission.

(ii) Rate Base

The Company continues to rely on orders from Case Nos. TR-77-214 and TR-79-213 to claim deferred taxes were created and flowed through to ratepayers. The Staff continues to assert that deferred taxes cannot be created by this tax deduction. Since tax depreciation cannot exceed the original cost of the investment, deferred taxes cannot be generated for the component (COR) cost of removal/salvage. Adding to this argument, the Staff's analysis from 1988-1992 reveals COR to be greater than salvage. Contrary to claims of irrelevance by the Company, this analysis clearly demonstrates that in order for deferred taxes to be generated for COR/salvage, tax depreciation would have to exceed 100% of the original cost of the investment. As noted above, this does not occur. The Commission should again rule in favor of Staff as it did in Case No. TC-89-14 as the conditions that existed then have not changed. Re Southwestern Bell, 29 Mo. P.S.C. (N.S.) 607, 620 (1989).

E. Non-Property Related Deferred Taxes

The deferred taxes at issue here relate to the Right-To-Use (RTU) fees incurred by SWBT. Company witness Toti admits as much.

(Toti Rebuttal, Ex. 37, p. 88). As the Commission will recall, RTU fees were abnormally high in 1992 and SWBT withdrew its RTU Fee Amortization proposal. (SWBT Brief, pp. 93-94). If these expenses are removed from cost of service (As SWBT concedes they should be), so too should the related deferred taxes.

The Commission should adopt the Staff's proposal concerning non-property related deferred taxes.

19. <u>Business Meals</u>

The Staff continues to support its proposal to remove business meal expenses from cost of service. The problems cited by the Commission as justification for disallowing these expenses in Case No. TC-89-14 continue to exist. Although the Company has somewhat improved its business meal expense reporting since Case No. TC-89-14, that reporting has not yet reached an acceptable level. (Tr. 673).

For example, the sample employee reimbursement form that SWBT offered into evidence (Ex. 47) shows no business purpose associated with a trip to the airport that is apparently reimbursable. In footnote 136 on page 156 of its initial brief, SWBT attempts to dismiss as isolated a case of employee fraud revealed by an Internal Audit Report. (Ex. 46P). The Staff asserts, however, that cases of employee fraud may have gone undetected because ". . . some detail on the voucher was insufficient, such as failing to attach original receipts, mathematical accuracy, etc." (SWBT Brief, p. 156). The Commission should also note that the per diem process mentioned on page 157 of SWBT's initial brief applies only to non-management employees. (Tr. 687). Management employees at SWBT have no such limitations.

Adoption of the Staff's proposal should motivate SWBT to improve its internal controls over business meal expenses.

20. Yellow Pages Adjustment

SWBT states that Judge Greene left Yellow Pages operations with RHCs to protect against a loss of subsidy that might have caused local exchange rates to increase. SWBT points out that its local exchange rates in Missouri have not increased since 1984. (SWBT Brief, p. 157). The use of the term subsidy is a blatant mischaracterization of the Yellow Pages issue. A subsidy is commonly defined as a grant or gift. (Webster's New Collegiate Dictionary, 150th Anniversary Edition 1981, p. 1153). This is no gift, grant or subsidy. The profits derived from Yellow Pages operations rightfully belong to SWBT regardless of whether these profits were generated in a separate subsidiary. Prior to 1984, Yellow Pages operations were handled by SWBT. Effective January 1, 1984, Yellow Pages operations were placed in a separate SBC subsidiary. (Featherstone Direct, Ex. 200, p. 6). The formation of a publishing subsidiary (now SWBYP) does not create a gift situation from one corporate entity to another where all operations of the two entities had previously been handled by one entity. To adopt SWBT's characterization of Yellow Pages profit imputation as a subsidy issue promotes form over substance.

The substance of this issue is reflected by the treatment of Yellow Pages operations revenues used by other local exchange companies. First, consider the treatment of the Yellow Pages operations by the seven Bell operating companies. Bell Atlantic never created a separate subsidiary for Yellow Pages operations. Thus, Bell Atlantic continues to treat Yellow Pages "exactly as it had prior to divestiture, that is, it was simply a part of the operations of the telephone company." (Featherstone Rebuttal, Ex. 201, Sch. 1-3). The creation of a separate subsidiary to publish telephone directories does not alter the relationship between the telephone company operations and the directory publishing operations. The publication of telephone directories within the operations of the telephone company, as is done by Bell Atlantic, is no different than the publication of telephone directories within a separate publishing subsidiary.

Six of the seven RBOCs moved the Yellow Pages operations to a separate subsidiary. Of those six RBOCs, SWBT is the <u>only</u> RBOC which does <u>not</u> have a structure whereby the Yellow Pages subsidiary makes an actual payment to the telephone company. (Featherstone Rebuttal, Ex. 201, Sch. 1-3). Through a contractual arrangement (publishing agreement), the publishing affiliates of the RBOCs other than SWBT and Bell Atlantic make payments of a specific amount of money to the telephone company which payments are known as publishing rights fees. Therefore, the other RBOCs have recognized the value associated with the right to be the exclusive publisher of the "official" telephone directory. SBC intentionally chose <u>not</u> to have an agreement whereby SWBT would receive a percentage of directory advertising revenue. (Staff Brief, p. 133; Featherstone Rebuttal, Ex. 201, p. 51). SWBT should not be permitted to remove the Yellow Pages directory advertising revenue because of an organizational structure of its own creation.

The creation of the separate subsidiaries by the RBOCs other than SWBT and Bell Atlantic was intended to remove substantial portions of directory advertising revenues from the telephone operations. In SWBT's case the creation of the separate subsidiary was intended to remove all the directory advertising revenues from SWBT. The only logical rationale for this act is to remove the profits of the most profitable entity, SWBYP, from SWBT to the benefit of SBC and the long-term detriment of SWBT and its telephone customers.

The numerous agreements identified between MAST (now known as Associated Director Services, Inc. (ADS)) in Staff witness Featherstone's Supplemental Surrebuttal Testimony provide additional irrefutable evidence of the value associated with the right to publish the official telephone directory. (Featherstone Supp. Surrebuttal, Ex. 203). These directories, (both White and Yellow Pages), represent a tremendous asset to SWBYP (because SWBT gave SWBYP these publishing rights) and SWBT should receive compensation from directory publications. This holds true because, in reality, publication of the telephone directories is the obligation of SWBT. Every other telephone company in the state as well as the majority of telephone companies around the country receive some form of compensation. SWBT should be no exception.

SWBT has completely mischaracterized how the inclusion of Yellow Pages revenues will impact rates. At page 158 of its initial brief, the Company states that 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).

The fact is touch-tone service, which does impact local exchanges rates, will be reduced by $4.3 million when the total revenue decrease is as little as $23 million. A $50 million reduction will result in an $11.5 million reduction to touch-tone services which would represent 23% of the reduction. When the rate reduction reaches $75 million, the reduction to touch-tone would be $27 million and if the reduction is $100 million the touch-tone reduction becomes $35 million, or 35% of the reduction. (Ex. 159, Sch. 2). Clearly the inclusion of Yellow Pages revenues in this complaint case does have a significant impact on overall rates, including local exchange rates, through reduction to touch-tone services.

SWBT's statements seem to suggest that the Commission need not include Yellow Pages revenues and expenses in the ratemaking process since SWBT's local exchange rates have not increased since 1984. Whether local exchange rates in Missouri have increased since 1984 is totally irrelevant to the Yellow Pages issue. Cost savings achieved in other areas by SWBT do not logically cause one to conclude that SBC shareholders should receive a windfall of Yellow Pages profits. In fact, SBC shareholders have already been enriched.

A document in this record which demonstrates a connection between Yellow Pages Consolidation and local exchange rates is Southwestern Bell's "Yellow Pages Imputation Policy Review." That document states that Mr. William Harrelson, then current General Counsel of the Missouri Public Service Commission, argued that Regional Holding Companies (RHCs or RBOCs) should retain Yellow Pages operations rather than AT&T so that Yellow Pages "revenues could be used to keep basic rates as low as possible." (Featherstone Rebuttal, Ex. 201, Sch. 1-2). The Staff is unaware of any information that Judge Greene's decision in the divestiture case applies only to the extent that local exchange rates actually increase after 1984. It appears to the Staff that Judge Greene granted RHCs the right to publish, print and distribute Yellow Pages under the name of the "official telephone company" in order to hold down local exchange rates as well as other rates. The circumstance of SWBT's local exchange rates having not increased above 1984 levels indicates that SWBT's local exchange rates have, in fact, been held down. The post-1984 experience of SWBT with local exchange rates is at least partially attributable to SBC's retention of Yellow Pages operations in conjunction with consolidation of Yellow Pages revenues and expenses into the ratemaking process.

The "Yellow Pages Imputation Policy Review" noted a general belief that absent direct intervention by state regulators with Judge Greene, "Yellow Pages revenues would not be a part of the Regional Bell Operating Companies" and would have been left as part of AT&T. (Featherstone Rebuttal, Ex. 201, Sch. 1-3). Thus, it was the work of state regulators which enabled SWBT to keep the very lucrative directory services operations. Now SBC wishes to have the profits therefrom inure to the benefit of SBC shareholders rather than SWBT ratepayers.

SWBT argues in its brief that there is no need to impute Yellow Pages revenues because SWBT is not proposing an increase in local exchange rates. (SWBT Brief, p. 158). Nowhere in testimony has SWBT advanced this position. (D. Robertson Direct, Ex. 48, pp. 22-23). The Staff has repeatedly stated throughout its testimony that if Yellow Pages revenues are not reflected in rates, a significant rate increase from other telephone services including local exchange service would be necessary. The Staff stated that the:

> . . . cost of local exchange service or other

> telephone service rates would have to increase significantly to compensate for the revenue requirement associated with the loss of Yellow Page directory contributions. (Featherstone Direct, Ex. 200, p. 37).

The Staff takes exception with SWBT advancing an entirely new position with regard to this issue in its brief. Nevertheless, the Staff would point out that whether local exchange rates decrease or increase as a result of this proceeding is simply not relevant. The proper analysis of the Yellow Pages imputation issue in connection with telephone service rates should be to consider the marginal impact on each rate category resulting from the consolidation of Yellow Pages revenues and expenses with those of SWBT.

SWBT characterizes Yellow Pages imputation as "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." As stated previously, use of Yellow Page operation results in the ratemaking process does not constitute a subsidy. The Yellow Pages revenues rightfully belong to SWBT because it possesses the telephone communications franchise which enables the publication of telephone directories. Furthermore, no evidence whatsoever has been submitted which indicates "competition in the telecommunications industry will eventually require the reduction and eventual elimination of subsidies." (SWBT Brief, p. 159).

SWBT suggests that the Staff's extensive audit in the Yellow Pages area was excessive in that the result was "to develop a recommendation that the Commission do what it had already stated it was going to do anyway in its Order of Case No. TC-89-14." (SWBT Brief, p. 159). The Staff does not believe that by virtue of simply proposing the continued use of the 1985 contribution level as stated in the Report and Order issued in Case No. TC-89-14, et al., that SWBT would have automatically accepted that position. The Staff believes that investigating SWBT's operations was necessary. Indeed, the Commission is well aware of the litigious nature of cases involving SWBT's rates. The only prudent course of action available to Staff was to thoroughly review SWBYP's operations. (Tr. 1930, 1935-36). In addition, the battle on the legislative front regarding the Yellow Pages issue lends further support to the view that SWBT would not likely accede to the Staff's position without the support provided by a thorough investigation into SWBT's and SWBYP's operations.

SWBT suggests that the focus of the audit "could have been limited to what, if any, adjustments could or should be made to" Yellow Page results from the 12 month period ending September 1992. (SWBT's Brief, p. 160). This suggestion by SWBT is obviously flawed in that the Yellow Page results for the 12 month period ending September 30, 1992, would not have been available until the Staff was well into its audit. Thus, the Staff made adjustments to Yellow Page results for the 12 month period ending December 31, 1991 in addition to presenting the 1985 level. Therefore, the Staff presented the Commission with several options from which to choose in this proceeding.

SWBT emphasizes the need to use "actual" Yellow Pages results. (SWBT Brief, p. 160). However, by carefully analyzing the recent history of the Yellow Pages issue, one finds that SWBT is willing to deviate from "actual results" when such deviation benefits SWBT. Specifically, the uncollectible adjustment which occurred in 1986 was never made to the books reflecting 1985 results. Thus, the uncollectible adjustment does not represent 1985 actual results which were and continue to be today $49,100,000. (Tr. 1979; Featherstone Surrebuttal, Ex. 202, p. 9). The 1985 adjusted level which SWBT advocates in this proceeding is not the actual results of Yellow Pages operations generated in 1985 as reflected on the books and records of SWBYP. (Tr. 1979). The $49,100,000 (actual 1985 results) does represent ongoing operations as reflected in the testimony of Staff witness Levins. (Levins Direct, Ex. 195, p. 11). This can readily be seen by reviewing the twelve month period ending September 30, 1992, and the twelve month period ending December 31, 1992, earnings levels of SWBYP. The figure for the twelve month period ending September 30, 1992, is $47,261,000 (Featherstone Surrebuttal, Ex. 202, p. 14); and for the twelve months ending December 31, 1992, is ** **[20]. (Sellers Rebuttal, Ex. 213, Proprietary Sch. 2-1).

SWBT states that "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." (SWBT Brief, p. 161). The Staff did not suggest that the Commission can simply "pick any number it chooses." Mr. Featherstone testified that the Commission had to have some "foundation and basis" for the amount which it uses for Yellow Pages, but the Commission is not limited to actual results. (Tr. 1904).

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20 The Staff's brief at p. 131 incorrectly identifies a contribution amount for the twelve months ending December 31, 1992 to be ** **. This amount did not reflect the business development adjustment. (Sellers Rebuttal, Ex. 213P, Sch. 2-1).

SWBT again implies that the Commission should be limited in some manner to using "actual results." (SWBT Brief, p. 161). As stated previously herein, SWBT was not only willing to adjust actual results in Case No. TC-89-14, et al., but SWBT itself proposed the uncollectible adjustment. (Tr. 1979; Featherstone Surrebuttal, Ex. 202, pp. 9-12). Additionally, in this proceeding SWBT is not advocating the use of SWBYP actual results. SWBT has proposed the use of the 12 month period ending September 30, 1992, with three adjustments:

1. Business Development Adjustment
2. White Pages Publishing Agreement Adjustment
3. Cost of Equity Adjustment

(Martin Rebuttal, Ex. 7, p. 63; Tr. 1932-1935; Featherstone Surrebuttal, Ex. 202, pp. 49, 53-70).

SWBT poses a question at the top of page 162 of its initial brief regarding the necessity of spending extensive Staff time on the Yellow Pages issue. The answer is probably obvious to the Commission, but now it requires articulation. It was necessary to spend extensive time and resources on the Yellow Pages issue to review data from 1983 to 1993 because of the complex and self-serving corporate structure created by SWBT in 1984. If the process has become complicated, arbitrary and burdensome, SWBT has only itself to blame. As stated by Mr. Featherstone:

> . . . anytime the public utility has a structure in place that promotes transactions between corporate affiliates when one of those affiliates is a regulated monopoly provider of public utility services, then it becomes the responsibility of the regulator to assess and evaluate those transactions. (Featherstone Rebuttal, Ex. 201, p. 98).

Through its investigation, the Staff has become aware of events which have occurred, such as the Custom Printing/Times Journal problem (Featherstone Direct, Ex. 200, pp. 60-98), and the Great Western law suit where SWBT and SWBYP collaborated to exclude directory competition in their Texas markets. (Featherstone Rebuttal, Ex. 201, p. 78). Given these abuses, close scrutiny of the SWBYP operations is clearly warranted. SWBT has certainly not shown itself worthy of a lesser degree of regulatory scrutiny in its corporate actions in running its business operations.

A further indication of the need to carefully audit SWBYP operations is demonstrated by the conduct of SBC, SWBT and SWBYP personnel in connection with the Great Western lawsuit. Information disclosed in that case showed that an officer of SWBYP initiated discussions regarding increasing directory listing rates charged to SWBT by SWBYP. Of course, SWBYP was not concerned about directory listing rates but rather the elimination of directory competition in their Texas markets. (Featherstone Rebuttal, Ex. 201, pp. 77-96, Sch. 10). It appears that SWBT and SWBYP developed marketing strategies jointly to suppress directory competition. These entities have a history of something more than simply a customer-supplier relationship. It also appears that SWBT engaged in some anti-competitive activities in connection with the printing of its directories as shown by its dealings with Custom Printing. (Featherstone Rebuttal, Ex. 200, pp. 60-98; Featherstone Surrebuttal, Ex. 202, pp. 21-23).

With respect to the WPPA adjustment and the cost of equity adjustment, SWBT completely ignored the Staff's testimony relating to those issues. (Featherstone Surrebuttal, Ex. 202, pp. 49-70). In fact, the Company did not cross-examine the Staff on any aspects of its surrebuttal testimony opposing those adjustments. In its initial brief SWBT asserts that the cost of equity adjustment is consistent with the Staff's Bellcore adjustment. (SWBT Brief, p. 162, footnote 141). First, the Bellcore issue has been settled. Second, in its initial brief SWBT does not disclose in what manner SWBT believes these two adjustments to be inconsistent. Furthermore, this line of reasoning was not disclosed at the hearing or in testimony.

It is ironic that SWBT states that September 1992 SWBYP results represent "actual results [that] are better than the adjusted 1985 results" yet SWBT advocates using the 1985 adjusted level on a frozen basis for at least three years and maybe longer. (SWBT Brief, p. 159, 163, Tr. 1931-32, 1975-76, 2018). Thus, SWBT proposes to freeze indefinitely the level of Yellow Pages contribution it believes to be not as good as the September 1992 level. (Tr. 1977).

A. SWBT's Cost of Equity Adjustment

In surrebuttal testimony, Staff witness Featherstone explained in detail the reasons that SWBT's proposed cost of equity adjustment is inappropriate and flawed. This criticism of SWBT's proposed cost of equity adjustment went unchallenged. SWBT's cost of equity adjustment is not appropriate because a substantial amount of this adjustment relates to accounts receivable. Accounts receivable balances are not a component of rate base. (Featherstone Surrebuttal, Ex. 202, p. 56). Accounts receivable are typically included as part of a company's cash working capital requirement which is determined through a lead lag analysis. (Id. at 56). The accounts receivable balance represents future cash payments by customers which payments provide the utility reimbursement for many types of costs it incurs in the provision of utility services, including a profit. (Id. at 58). Part of the costs recovered through accounts receivables relate to depreciation, deferred taxes and profit which is not considered in the lead/lag analysis. Deprecation and deferred taxes are not considered in a lead/lag analysis because they represent non-cash items and fall outside the intent and purpose of the analysis. The profit component of accounts receivables is excluded from the lead/lag analysis because it is inappropriate to provide a return on the profit. These items have consistently been excluded by the Commission from the lead/lag analysis. (Id. at 59).

SWBT did not present a lead/lag analysis in this case, hence one can only speculate what level of cash working capital exists. (Id. at 62). Typically, a lead/lag analysis determines negative cash working capital which reduces rate base. (Id. at 58, 60). SWBT's cost of equity adjustment is one-sided in that it ignores the outflow of cash on the liability side of the balance sheet which would be the offset to the accounts receivable or asset side. Thus, SWBT's proposal is overstated. (Id. at 61, 63).

The Staff conservatively left the cash working capital requirement for SWBYP at zero, since in most cases, it is negative which would have the effect of reducing rate base. (Id. at 62).

If SWBT is actually failing to recover investment in accounts receivable, prepayments, plant and equipment, it should allocate those investments to the Missouri rate base and perform a lead/lag analysis. It is important to note that accounts receivable is the revenue stream that generates cash for the utility and thus cannot generate a cash working capital requirement as SWBT proposes here.

(_Id._ at 62).

SWBT's proposed cost of equity adjustment assumes SWBT finances its investment with accounts receivables and prepayments entirely with equity. This would not be economical when SWBT could, if necessary, finance these items with low cost short-term debt. (_Id._ at 67).

The Staff has not removed interest expense from SWBYP's income statement, which reduces the Yellow Page contribution. The deferred directory costs included in rate base also create a revenue requirement so SWBYP can meet its debt obligations. In effect, SWBYP will receive an additional amount of interest expense in this case resulting in a greater revenue requirement that would otherwise result. (_Id._ at 68-69).

Finally, since SWBYP's capital structure contains more equity than SWBT's, the cost of equity adjustment circumvents SWBT's capital structure (_Id._ at 69) which the Staff believes to be inappropriate.

B. Competition

SWBT maintains that it encounters "significant competition" in seeking to maintain or increase its advertising revenues in Missouri. (SWBT Brief, p. 164). SWBT attempts to shift the Commission's attention from competing directories to other advertising media such as newspapers, T.V., cable T.V., radio and magazines. This strategy is employed because evidence relating to the directories market shows an overwhelming dominance by SWBT. SWBT's directory in St. Louis achieved a 99.2% usage compared with the Old Heritage directory which achieved 0.8%. SWBT's Kansas City directory has comparable usage to the St. Louis directory. (Levins Direct, Ex. 195, p. 32; Tr. 1949). The substantial record evidence in this proceeding which proves the relevance of usage studies to the measurement of competition in the directories market is provided at pages 145-149 of the Staff's initial brief.

In addition to usage study data showing overwhelming reliance upon SWBYP directories in the Kansas City and St. Louis markets, considered the astronomical returns that SWBT has achieved in recent years. In 1990, SWBT had a return on average equity of ** ** percent. In 1991, its return on average equity was ** ** percent and in 1992 ** ** percent. (Featherstone Direct, Ex. 200, p. 41). In a competitive market, firms simply do not achieve these levels of returns year after year because the extraordinarily high returns attract competitors and prices are driven down thus reducing profit margins. Quoting from Staff witness Johnson's testimony:

> In some markets, there is just one directory published: that endorsed or published by the local exchange company. In a few markets, alternative directories are available. However, the number of supplying firms is always small -- typically just one or two other firms attempt to compete with the directory which is affiliated with the local exchange company. As a result of the small number of firms participating in the market, and because the affiliated directory enjoys a dominant market share, it can readily restrict the total amount of directory advertising supply to the market, and it can sustain very high prices which consistently generate supra - competitive (monopoly) profits. (Id. at p. 35).

Another important indication of the competitive characteristics of this market is SWPYP's ability to increase directory prices and not suffer a significant decrease in market share. (Levins Surrebuttal, Ex. 196, p. 73-74). SWBYP has been able to successfully increase Yellow Pages revenues in Missouri over the last several years. (Id. at 65). In fact, SWBYP's revenue growth has been significantly better than the industry average. (Id. at 66).

All these factors taken together show that SWBYP faces less competition today than compared to the Commission findings in Case No. TC-89-14 wherein the Commission found there to be insignificant competition in the Missouri directory market. Re Southwestern Bell, 29 Mo. P.S.C. 605, 642 (1989).

Footnote 146 on page 166 of SWBT's initial brief is highly misleading. (fn. 146). The lost sales of 17% each year mentioned by SWBT actually refers to 6 to 6.5% of customers cancelling their advertising and another 10.5 to 11% of customers who reduce or adjust their advertising programs. (Tr. 2131). Naturally, as businesses relocate or close, there will be changes reflected in the Yellow Pages. As far as the bottom line, in St. Louis there was a **___** gain and in Kansas City there was a **________** gain. (Levins Surrebuttal, Ex. 196, pp. 56-58). SWBYP has been very effective in regaining lost sales and more thus a further indication that competition has not adversely impacted the marketing of these directories.

At page 167 of its initial brief, SWBT brings up the argument of whether Yellow Pages directory operations are an essential part of telephone service. This Commission has found in previous cases:

> . . . that the furnishing of telephone directories is an essential element of telephone service and advertising contained therein is not separable from the directory itself. The listings and the advertising are intermingled throughout the directory. Re United Telephone Company, 24 Mo. P.S.C. (N.S.) 152, 172-173 (1981).

Other states have found Yellow Pages operations to be an essential part of telephone service. In a North Carolina Court of Appeals decision, the Court stated:

> [T]he furnishing of classified advertising by telephone company, more commonly known as the Yellow Pages, is an essential part of the service it provides. As a result, Yellow pages revenues and expenses should be included in the revenues and expenses of the Company when it applies for a rate increase. North Carolina ex rel. Utilities Commission v. Central Telephone Company, 299 S.E.2d 264 (1983).

SWBT states that it is not reasonable that an imputation amount in excess of actual earnings realized from Yellow Pages operations should be used for ratemaking. (SWBT Brief, p. 168). None of the Staff's proposals are hypothetical imputation amounts which are more than actual earnings realized from Yellow Pages operations. (Levins Direct, Ex. 195, p. 22; Featherstone Surrebuttal, Ex. 202, p. 14; Martin Rebuttal, Ex. 7, p. 63).

As stated previously, a majority of telephone companies around the country receive publishing rights fees from publishers who obtain their contractual right to publish the official telephone directory. However, SWBT receives no such fees from SWBYP. At pages 168-169 of its initial brief SWBT implies that the failure of SWBYP to collect publishing rights fees from SWBYP is relevant to the extent that SWBYP's directory revenues comes from co-bound directories. The only reason that the Kansas City and St. Louis directories are not co-bound is simply because those directories are enormous. Whether particular directories are co-bound or not has absolutely no relationship to the fact that SWBT does not collect one thin dime from SWBYP for the publishing rights that SWBT has given to SWBYP. In fact, as stated in the Staff's initial brief, SWBT reimburses SWBYP for virtually all the costs associated with publishing the White Pages directories in addition to a 2% management fee. Do not allow SWBT to mislead you into believing that the thickness of its directories in Kansas City and St. Louis has a relationship to the value of the Yellow Pages issue.

C. Conclusion

The Staff respectfully submits that the Commission should continue its long-standing policy of considering the Yellow Pages revenues and expenses as part of SWBT operations. Telephone rates will be significantly impacted if Yellow Pages revenues are not maintained as part of SWBT's rate structure. Southwestern Bell directories have been more than successful in the directory marketplace in Missouri. The compensation relating to SWBYP operations flowing to SWBT through the consolidation is nothing more than the standard industry practice of a publishing rights fee to which SWBT is entitled since these directories represent a real asset to the telephone company. It is only fitting that this historical practice continue regardless of how SWBT and SWBYP are organizationally structured. The Commission has broad authority to consider Yellow Page revenues in SWBT rates and should continue to do so based upon the overwhelming evidence in support of this practice.

21. Annualization/Year Ending

A. Revenues

In Case No. TC-89-14 the Commission stated that:

> [A]n analysis must be made of revenues and expenses to determine whether year-end levels are representative of the levels that can be expected to occur when the rates are in effect. Re Southwestern Bell, 29 Mo. P.S.C. (N.S.) 607, 615 (1989).

Such an analysis supports the total annualized level of revenues recommended by the Staff. In footnote 156 on page 170 of its initial brief SWBT complains that the revenue level proposed by the Staff exceeds 1992 actuals by a considerable amount that will not be reached until late in 1993. This is wrong; not only have revenues been continually rising since the end of the update period (September 30, 1992), but as of March 1993 SWBT's actual annual revenues (i.e., for the 12 months ending March 1993) exceeded the revenue level proposed by the Staff on an overall basis. (Rucker Surrebuttal, Ex. 28 HC, Sch. 1[21]). The Company's concerns about the 1993 level of revenues are ironic given the massive revenue requirement increases it has proposed for events occurring subsequent to the update period. Although record evidence supports the increasing level of revenues after the update period, the revenue requirement impact of these revenues is not included as an offset to the Company's proposed post-update period isolated adjustments.

In footnote 155 on page 170 of its initial brief SWBT asserts that its graphs show that the Staff's level of toll and access revenues is overstated. The Staff asks the Commission to view the graphs from a different angle. Although the toll graphs may indicate an overall decrease from 1990 to 1992, the Company failed to mention that toll appears to be on the upswing in 1992, which is reflected in both the business and residence graphs (Martin Rebuttal [Revised], Ex. 7, Sch. 11-2) by the close proximity of 1992 results to 1991 results. Moveover, the residence graph indicates several months in 1992 that exceed those in 1991. The graph depicting access revenues show a continual increase from 1990-1992. (Id. at Sch. 11-1).

[21]This schedule also shows that the Staff's proposed level of uncollectibles is reasonable in light of both actual experience and SWBT projections.

Although September may have been the highest month in 1992, historical trends indicate that that level will be surpassed in 1993.

On page 171 of its initial brief SWBT levels erroneous criticisms at the Staff's use of the Company's budgeted level of revenues as a reasonableness test for its revenue annualization and the asserted Staff disregard for the revenue/expense/rate base relationship on a going forward basis. First, as indicated earlier, actual 1993 results show how conservative the Staff's revenue annualization actually is. (Rucker Surrebuttal, Ex. 28HC, Sch. 1). Second, although SWBT insists throughout its initial brief that the Staff has not analyzed the revenue/expense/rate base relationship, the evidence in this record indicates that for SWBT, rate base additions are accompanied by both revenue increases <u>and</u> expense decreases. Therefore, the Staff's conservative revenue annualization does not distort an appropriate revenue/expense/rate base relationship.

In footnote 159 on page 172 of its initial brief, SWBT states that the Staff made no attempt to rebut Ms. Martin's point that non-recurring charges occur in higher proportion in September. Simple common sense rebuts the statement. Because school typically starts in late August and because students typically hook their phones up before school starts, new connects will be higher in August than in September. In fact, this common sense is borne out by the evidence which shows that the rate for non-recurring local service (residence) revenues per access line for the months of May, June, July <u>and</u> August of 1992 exceeded those produced in September of 1992. (Rucker Surrebuttal, Ex. 28HC, Sch. 4).

In summary, the Staff must reiterate the importance of looking at the revenue issue in its totality. Examination of the individual revenue components is necessary to thoroughly understand the overall revenue annualization process. The Staff's examination and annualization of these individual components in the context of developing the appropriate level of revenues to be achieved overall ultimately determined the Staff's overall revenue annualization. The Staff continues to assert that both its individual annualizations and its total annualized level of revenues are reasonable on a going forward basis. Failure to adopt the Staff's proposed revenue annualization will distort an appropriate revenue/expense/rate base relationship and put SWBT in an excess earnings position once again.

1. Access/Billing and Collection expense

The Staff concedes that access charge units as an expense item directly relate to units of toll that produce revenues. Thus, the adjustment proposed by SWBT is appropriate if the Commission adopts the revenue annualization proposed by the Staff. On page 175 of its initial brief, however, the Company appears to be arguing that the Commission should adopt SWBT's lower level of proposed toll revenues and the higher level of access expenses associated with the Staff's toll revenue annualization. This is inappropriate and should be rejected.

B. Expenses

1. Non-Wage End-Of-Period (Annualization)

The Staff does not understand how non-wage expenses could have materially increased from December 31, 1991, to September 30, 1992, if SWBT actually pursued efficiencies, as it claims it did, during the course of the experiment. The Commission should recall that SWBT employee levels dropped during that time period. (Tunks Direct, Ex. 175, p. 5). Many of the items SWBT seeks to inflate by use of the Gross National Product-Implicit Price Deflator (GNP-IPD) should drop with employee levels (e.g., office supplies, gasoline, health care, rent, computer paper). This exposes a major problem with SWBT's proposal; it increases expenses for inflation but fails to account for offsetting productivity gains (such as project Quest). (Schallenberg Surrebuttal, Ex. 31, p. 29).

On page 174 of its initial brief, SWBT argues that the Staff should have been able to isolate the components of SWBT's non-wage end-of-period annualization because the Staff did so in its cash working capital (CWC) adjustment. SWBT is attempting to mix monkeys and moonshine. The purpose of the cash working capital (CWC) analysis shown on Exhibit 189 is to establish the bill payment practices of SWBT. Although dollars are used for weighting purposes, the analysis measures time periods, not expense levels. The dollar levels shown are strictly historical and were used by the Staff for purposes of the CWC calculation without any attempt to determine whether those levels are reasonably representative of past history or reasonably to be expected on a forward looking basis. Moreover, the analysis shown on Exhibit 189 was produced from a study of the test year - the twelve months ending December 31, 1991 (Tr. 1771); it does not purport to show any differences in expense levels between the end of the test year and the end of the update period - the twelve months ending September 30, 1992. Furthermore, as can be seen from review of Exhibit 189 the majority of the Non-Payroll expense dollars is attributed to the category of "Other Expense". There is no delineation of what "types of expenses are included in "Other Expense". Therefore for SWBT to suggest that this data can be relied on to audit the non-wage area is totally unfounded.

This type of adjustment has been proposed by utilities many times in the past and the Commission has never adopted the Company's position. The Commission should not do so now.

2.&3. Affiliate Transactions And Other

Because SWBT did not address these sub-issues in its initial brief the Staff cannot respond.

## III. ALTERNATIVE REGULATION

On page 175 of its initial brief, SWBT claims that the experiment promotes efficiencies. Two pages earlier it argued for the application of an inflation adjustment to various and sundry non-wage expense items without accounting for any productivity gains. The Company also claims that because the telecommunications industry is changing, so too must regulation. (SWBT Brief, p. 175). If the industry is as dynamic as SWBT claims, the Company should not, as SWBT does, rely on a study conducted in 1988-1989 as support for inflating non-wage expenses by the gross National Product-Implicit Price Deflator. (Tr. 661).

SWBT has asserted that traditional rate base/rate of return regulation creates the incentive for utilities to "gold-plate", or to invest in the absence of economic justification. (Wilk Direct, Ex. 56, p. 15). Nevertheless, SWBT touts the encouragement to invest (without regard to economic justification, the Staff asserts) as a major benefit of an alternative regulatory framework (ARF). (SWBT Brief, p. 176). SWBT continues by claiming that, absent the experiment, rural Missouri would not have the additional services and quality of service available to it today, adding that the Commission's new basic local service rule proves the failure of traditional regulation in this regard. (*Id.*). First, the record shows that many rural LECs in the State that have not undergone an ARF are already in full compliance with the Commission's new basic local service rule; SWBT itself is not yet in full compliance with the rule. (Tr. 1121). Second, if competition is truly emerging in the rural areas of the State, SWBT should need no inducement to install the equipment necessary for it to remain competitive. Third, if the rural markets are not seeing increased competition and economic justification for investment there is marginal or non-existent, then the experiment has simply continued the "gold plating" effect that SWBT claims to be one of traditional regulation's failures. Fourth, if competition ultimately emerges in rural Missouri, "inducing" SWBT to invest there now will virtually guarantee that SWBT maintains a solid if not insurmountable competitive advantage in the future. Given all of this, the relationship between network modernization and an ARF asserted by SWBT is nebulous at best.

The Staff has seen no evidence that the presence or absence of an ARF materially affects the amount SWBT invests in each of the states in its five state service territory. (Meyer Rebuttal, Ex. 3, pp. 3-4). The Staff does not believe that prior to the initiation of the experiment in 1990 that SWBT made investment decisions without regard to achievable returns. The returns SWBT alleges it would achieve if the Commission implemented the full $150 million rate reduction established by the Staff's case are vastly understated. The Company's calculation erroneously treats the Staff's $150 million recommended rate reduction as being totally related to ROE reductions. (Schallenberg Rebuttal, Ex. 30, p. 9). If this was true, only one issue would have been tried in this case, ROE, and it would have been valued in the reconciliation at $150 million. Only a cursory glance at the Hearing Memorandum (Ex. 1) and reconciliation (Ex. 244) reveals the falsity of this notion. The Company's calculation also includes the effect of the FAS 106 Transition Benefit Obligation (TBO) that SWBT wrote off in 1993. The TBO can only be written off once and thus must be backed out of the Company's projections for 1994 and 1995. Making this correction alone increases the Company's ROE projections by roughly 150 basis points. (Schallenberg Rebuttal, Ex. 30, p. 11). The Company's ROE projections also fail to consider, among other things, the Staff's treatment of the KCDC as regulated, the Staff's recommended depreciation rates and the Staff's income tax calculation. Correction of these errors increases SWBT's ROE projections by 100 and 130 basis points for 1994 and 1995, respectively. (Id. at 12). All in all, SWBT should be able to earn the Staff's recommended ROE if the Commission adopts the Staff's positions. (Id.).

In opening, counsel for SWBT asserted that SWBT was not holding modernization hostage in order to prevent rate cuts greater than that proposed by the Company itself. (Tr. 62-63). On page 181 of its initial brief, however, SWBT makes it clear that:

> . . . the incremental investment included in SWB's proposal for extending the plan is also directly related to a rejection of Staff's earnings complaint and continuation of the current plan without major changes in SWBT's earnings opportunities.

The tone of this passage certainly sounds like hostage-taking to the Staff and the substance ignores the realities of a competitive market (under which SWBT claims it operates) which precludes the permanent (or even extended) retention of efficiency gains. (Goldammer Rebuttal, Ex. 94, p. 16).

The Staff has questioned whether SWBT will actually spend the $82 million, or whatever the figure presently is, it has promised to invest as a part of its network modernization proposal. Acknowledging this possibility, SWBT has agreed to ". . . work with Staff and OPC to insure committed investments would be made in other worth while projects." (SWBT Brief, p. 182, footnote 169). This is a remarkable attitude turn-around, for it was only on page 169, footnote 154 that SWBT warned that:

> [T]he 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).

Such inconsistencies bring to the Staff's mind the relatively recent film, "Say Anything."

If the demand for telemedicine and distance learning services is as high as SWBT's initial brief indicates (at p. 186), then there must be a market for these services. If the services are profitable, the Staff believes that SWBT should be willing to make the investment necessary to serve these markets. If these services are not projected to be profitable, then fundamental economics dictate that the investment needed to serve these markets not be made. Using excess earnings as an inducement should not play a part in either scenario.

Beginning on page 190 of its initial brief SWBT addresses the subject of competition. The Commission should keep in mind that all utilities face competition.[22] The real question thus, is whether the competition that exists is meaningful. The Staff does not believe that SWBT has established the existence of meaningful competition. First, SWBT's intraLATA message toll service (MTS) while subject to some competition, will not be subject to meaningful competition until the advent of intra-LATA presubscription, which SWBT opposes. (Goldammer Rebuttal, Ex. 94, pp. 13-14; Tr. 803). Second, in Case No. TO-93-116, the Commission classified SWBT's MTS as transitionally competitive which gives SWBT the opportunity to obtain pricing flexibility to deal with the competitive pressures facing its MTS. (Goldammer Rebuttal, Ex. 94, pp. 8-10). SWBT has not yet availed itself of this aspect of the transitionally competitive classification of its MTS. (Id. at 11). That same situation holds true for other of SWBT's services, including: operator services, 800 services, Wide Area Telecommunications Service (WATS) and private line services. (Id. at 9). Apparently, existing competition is not sufficient to motivate SWBT to make use of the transitionally competitive status granted in Case No. TO-93-116.

On page 192 of its initial brief, SWBT speculates that the FCC's recent collocation orders ". . . will have a dramatic effect on SWB's toll and access revenues." First, speculation and conjecture such as this do not constitute competent and substantial evidence. State ex rel. Oliver v. PSC, 542 S.W.2d 595, 602 (Mo. App. 1976). Second, the Staff does not expect major changes in the growth of competition in the next few years and, if the Staff's recommended rate design is adopted, competitive inroads against SWBT's services

[22]For example, electricity providers compete with gas providers and vice versa.

may be somewhat reversed. (Goldammer Rebuttal, Ex. 94, p. 13). SWBT's ominous portent of the "end of the local exchange monopoly" (SWBT Brief, p. 192) cannot happen in Missouri absent a statutory change. §392.450. The Staff doubts that SWBT would allow this to happen in the next few years.

In summary, pricing flexibility, not an ARF, is all that SWBT needs to deal effectively with competitive pressures. SWBT should at least try to avail itself of the existing statutory framework before it uses competition as a rallying cry for alternative regulation.

## IV. RATE DESIGN

Nearly all of the parties in their initial briefs recommended support for the rate design stipulation reached in this case by the Staff, OPC, SWBT, AT&T, MCI, CompTel, and the Attorney General. While not all parties were signatories to the Stipulation, all parties, with the exception of one, voiced support for the vast majority of the issues which were agreed upon in the Stipulation. The one exception was the Midwest Independent Coin Payphone Association (MICPA).

MICPA asserts that SWBT's current rate structure, under which it offers access to MICPA's non-LEC payphone (NLPP) members, is unreasonable. It suggests that SWBT should provide this access under the following criteria:

(1) SWBT should not be allowed to charge a per minute rate for SWBT's provision of local calling to NLPPs, and

(2) SWBT should charge NLPPs the flat rate 1-party monthly business rate for access to SWBT's network.

The Staff disagrees with MICPA's suggestions and recommends that the Commission not implement them.

MICPA suggests that SWBT should not be authorized to charge a usage sensitive rate for the provision of local calling to NLPPs. MICPA asserts that SWBT's usage sensitive charges paid by NLPPs are inappropriate because of the Commission's 25¢ cap placed on unlimited length, local calls provided to the public via either SWB payphones or NLPPs (MICPA Brief, p. 19). MICPA stresses that ". . . it sends the message to the wrong person. The NLPP who cannot control either the time or distance of the call sees a variable rate that can exceed his revenue from the call." (MICPA Brief, p. 19). MICPA, however, also asserts that SWBT incurs costs associated with COPT usage. (MICPA Brief, p. 17). The Staff is confused by MICPA's conflicting statements. Stating that economic messages should be sent to the appropriate parties while asking that even though SWBT incurs costs associated with NLPP usage, it should not be able to charge usage sensitive rates is blatantly self-serving. MICPA is obviously not interested in solving any economic problems associated with the current rate structure, its only interest seems to be to shift any burden caused by the current rate structure from itself to other customers of SWBT.

The Staff does not agree with MICPA's recommendation to shift any burden caused by non-usage based rates for usage sensitive costs. The Staff realizes that currently NLPPs are required to charge a flat fee (because of the Commission's 25¢ cap on local calling) for a service which they pay for on a usage sensitive basis. The Staff does not, however, agree with MICPA's "solution". It seems more appropriate to resolve this problem rather than to shift the problem to another party. This is exactly the reasoning behind the Staff's recommendation to open a docket specifically aimed at resolving several problems inherent in today's payphone marketplace.

MICPA also asserts that it should be charged the 1-party, flat rate business local exchange rate for access to SWBT's network. The Staff does not agree and sees no reason why a service which has never been based on its costs (business local exchange rates) should serve as the basis for a service which everyone agrees should be based on its costs. MICPA even asserts that "MICPA is not seeking a rate below the incremental cost of service. . ." (MICPA Brief, p. 29). The Staff appreciates MICPA's willingness to pay for at least the imcremental costs associated with the provision of COPT service, yet is confused as to what this has to do with the current flat rate 1-party business rate. The Staff is very interested in determining the cost of COPT service as well as the costs of SWBT's public payphone services yet would like to do it in a much more comprehensive manner than MICPA witness Segal's scant calculations. (Ex. 157 and 158). This, is another reason why the Staff believes that a docket designed to address these issues in detail is much more appropriate than merely accepting the slap-dash approach recommended by MICPA.

MICPA attacks the stipulation filed by the parties mentioned above on the following ground:

> It is apparent that in the case of switched access SWB is willing to offer local transport in bands 1 and 2 below its incremental cost. . . (MICPA Brief, pp. 27 and 28).

This is simply untrue. As a signatory to the stipulation, one of the Staff's major concerns was that rate adjustments not move rate elements below their incremental cost. According to the most recent incremental cost studies of SWBT's access services (completed in 1991), the rates included in the stipulation not only recover their incremental costs but also include contribution to common overhead costs. (Starkey Direct, Ex. 143, p. 7).

MICPA also asserts that "Message toll service rates should not be reduced as a part of this case". (MICPA Brief p. 30). MICPA's recommendation seems to be based on the following statement, "It is clear from the statutes that the prices of transitionally competitive and competitive services are to be determined by market forces and not by the Commission. (The only qualification would be the Commission's authority and obligation to prevent below cost pricing and cross subsidization from non-competitive services.)" (MICPA Brief, p. 31).

The Staff disagrees that companies filing services as transitionally competitive are removed from the Commission's authority to set at least the initial rate levels of those services. The Staff can easily conceive of markets where, though competitive or transitionally competitive under §392.361, a strong market leader dominates the prices charged for specific services. In these instances, it is obviously in the public's interest for the Commission to use what authority it has to set at least the initial rates of such a service at an appropriate level, where possible. The Staff believes that intraLATA MTS is a service showing possible market price leadership characteristics and that in this case lowering those rates in order to benefit the general public is possible and within the Commission's authority. For this reason, the Staff continues to support the MTS reductions included in the stipulation. Additionally, MTS is presently priced well above its incremental cost and reduced MTS rates would benefit a large number of customers. Finally, SWBT's desires to reduce MTS rates is in response to competition in the intraLATA market, such as it presently exists. This is exactly what MICPA believes should be happening.

MICPA also asserts that "Finally, experience has demonstrated that as rates for long distance service are reduced usage increases. (This rate decrease has been proposed without any offset for the effect of call stimulation)". (MICPA Brief, p. 33). Once again, this is simply not true. Paragraph 3 of the stipulation states, "The actual rates of these services would be determined based on achieving the ordered revenue reduction." Staff witness Starkey also states:

> MTS rates would need to be reduced by a higher percentage in order to account for usage stimulation. For instance, I anticipate that lower MTS rates will encourage customers to use the service more. In order to calculate the exact percentage MTS rate reduction, I would be willing to use SWB's established model to calculate stimulation percentages. (Starkey Direct, Ex. 143, page 9, lines 8-12).

MICPA also attacks SWBT's previous proposal to include payphones in the 3rd and 4th tier WASP calling scope. The Staff also continues to oppose this proposal, however, this proposal is not included in the stipulation.

In summary, the Staff continues to support the Stipulation offered as Exhibit No. 159. The Staff also continues to support a future docket designed to address any problems that are apparent in the current provision of payphone service to the public. Such a docket would allow a comprehensive review of the entire industry including but not limited to the rates that SWBT charges COPTs operating in its territories. The Staff does not, however, agree with or support MICPA's suggestions contained in its initial brief.

## IV. CONCLUSION

For all of the foregoing reasons in addition to those set forth in its evidence and initial brief, the Staff respectfully requests that the Commission issue its order adopting the Staff's positions.

Respectfully submitted,

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## CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 1st day of October, 1993.

Robert J. Hack