R&O Binder

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of GTE North Incorporated of Westfield, Indiana, for authority to file tariffs increasing rates for telephone service to customers in the Missouri Division of its system.	)	Case No. TR-89-182
In the matter of the tariffs of GTE North Incorporated for billing and collection services	)	Case No. TR-89-238
The Staff of the Missouri Public Service Commission, Complainant, v. GTE North Incorporated, Respondent.	)	Case No. TC-90-75

REPORT AND ORDER

Date Issued: February 9, 1990

Date Effective: February 20, 1990

APPEARANCES: Dale E. Sporleder, General Counsel, William H. Keating, Associate General Counsel, A. Randall Vogelzang, P. O. Box 407, Westfield, Indiana 46074, and W. R. England, III, Attorney at Law, Hawkins, Brydon, Swearengen & England, P.C., P. O. Box 456, Jefferson City, Missouri 65102-0456, and James C. Stroo, Attorney at Law, 5205 North O'Conner, Irving, Texas 75039, for GTE North Incorporated.

W. Richard Morris, Attorney at Law, 1100 Walnut, Room 2430, P. O. Box 419418, Kansas City, Missouri 64141-6418, and Paul S. DeFord, Attorney at Law, Lathrop, Koontz & Norquist, 2345 Grand Avenue, Kansas City, Missouri 64108, for AT&T Communications of the Southwest, Inc.

Carl J. Lumley, Attorney at Law, Curtis, Oetting, Brackman & Crossen, P.C., 130 South Bemiston, Suite 200, Clayton, Missouri 63105, for MCI Telecommunications Corporation.

David K. Knowles, Senior Attorney, 5454 West 110th Street, Overland Park, Kansas 66211, for United Telephone Company of Missouri.

Katherine C. Swaller, Attorney at Law, Roger K. Toppins, Attorney at Law, Paula J. Fulks, Attorney at Law, 100 North Tucker Boulevard, Room 630, St. Louis, Missouri 63101-1976, for Southwestern Bell Telephone Company.

W. R. England, III, Attorney at Law, and Paul A. Boudreau, Attorney at Law, Hawkins, Brydon, Swearengen & England, P.C., P. O. Box 456, Jefferson City, Missouri 65102-9456, for Contel System of Missouri, Inc. and Contel of Missouri, Inc.

Mark D. Wheatley, Assistant Public Counsel, and Janet L. Sievert, Assistant Public Counsel, P. O. Box 7800, Jefferson City, Missouri 65102, for the Office of the Public Counsel and the Public.

Steven Dottheim, Deputy General Counsel, Linda K. Ohlemeyer, Deputy General Counsel, Richard W. French, Deputy General Counsel, Penny G. Baker, Assistant General Counsel, and Robert J. Hack, Assistant General Counsel, P. O. Box 360, Jefferson City, Missouri 65102, for the Staff of the Missouri Public Service Commission.

HEARING EXAMINER: C. Gene Fee

INDEX

CASES NOS. TR-89-182, TR-89-238 and TC-90-75

I. PROCEDURAL HISTORY

On March 23, 1989, GTE North Incorporated (GTE North or Company) filed for Commission approval proposed tariffs reflecting an annual increase of $8,355,000 in gross revenues exclusive of gross receipts and certain other taxes, for the provision of basic local exchange telephone service as well as other services. The proposed increases were coupled with proposed decreased rates for toll and access service. The revised tariffs which bore an effective date of April 22, 1989, were to be phased in over a five-year period with the most substantial portion of the increases in the first year.

By an order issued April 19, 1989, the proposed tariffs were suspended to February 20, 1990, and a procedural schedule was established for consideration of the suspended tariffs. The suspended tariffs included the request for depreciation rates and accounting treatment pending in Case No. TO-89-77. The Commission, by order issued April 25, 1989, dismissed that docket.

Timely applications to intervene filed by AT&T Communications of the Southwest, Inc. (AT&T), AT&T Information System, Inc. (AT&T-IS), Southwestern Bell Telephone Company (SWBT), Contel of Missouri, Inc. and Contel System of Missouri, Inc. (Contel), MCI Telecommunications Corporation (MCI) and United Telephone Company of Missouri (United), were granted by Commission order issued July 11, 1989.

On May 2, 1989, Company filed proposed revised tariffs providing for a five percent (5%) rate reduction for its billing and collection services. On May 30, 1989, the Commission suspended those proposed tariffs, docketed the filings in Case No. TR-89-238, and consolidated the case with Case No. TR-89-182.

Local public hearings have been held in this matter in the cities of Osceola, Cameron, Columbia and Ava on September 19, September 26, October 3 and October 10, respectively.

Pursuant to a Commission authorization, the Commission Staff, on September 29, 1989, filed a complaint against the rates of the Company seeking an overall reduction in the Company's revenues in an amount varying from $2,956,000 to $3,690,000 depending on the appropriate rate of return determined. The complaint, docketed as Case No. TC-90-75, was consolidated for hearing under the existing procedural schedule.

A prehearing conference was held in this matter on October 16, 1989. Issues settled at that time have adjusted the Company's request to $7,683,000. Technical and financial evidence was presented in hearings commencing October 30, 1989 and ending November 9, 1989. The record was completed with the filing of reply briefs on January 3, 1990.

In response to a motion by the Company, the Commission has issued a protective order in this matter providing for the filing of testimony involving the Company's proprietary information in either PROPRIETARY or HIGHLY CONFIDENTIAL form. Those documents, as well as certain portions of the transcript of in-camera proceedings, are included in the record under seal and may be reviewed only by persons enumerated in the protective order.

II. THE COMPANY

GTE North is a successor to a group of eight telephone companies, one of which, General Telephone Company of the Midwest, had rendered service in the States of Missouri, Iowa and Nebraska. In addition to those states, GTE North renders service to Ohio, Illinois, Indiana, Michigan, Pennsylvania, Wisconsin and Minnesota. The stock of the Company is not publicly traded, but is held in its entirety by GTE Corporation (GTE or Parent). GTE is the largest U.S.

utility according to FORTUNE magazine with operations in 48 states and 33 countries.

III. TEST YEAR/TRUE UP

The parties in this matter have agreed on a test year of 12 months ending December 31, 1988. The Company and the Staff do not agree on certain post-test year adjustments. One of those adjustments is the proposed inclusion by the Company of rate case expense. It is the position of the Commission Staff that the Company has proposed a true-up on this inclusion, whereas, the Company contends that quantification of rate case expense is not a true-up. The propriety of including post-test year results is addressed in the succeeding portions of the order discussing each issue.

IV. RATE BASE

The Company proposes its rates be set on a Missouri intrastate rate base of $85,528,000. Staff, by virtue of pertinent adjustments hereinafter discussed, contends the intrastate rate base of the Company to be $70,992,000.

1. The DMS-100 Switch

The Staff recommends disallowance of $689,000 of investment associated with the installation of a NORTHERN TELECOM DMS-100 switch. Staff alleges that the investment was wrongfully allocated to the Company's non-University of Missouri customers and was installed solely to enable the Company to retain the University as a lucrative customer for both regulated and unregulated services.

In May of 1985, the University of Missouri issued a REQUEST FOR PROPOSAL for a new digital telephone system for the Columbia campus. At that time, a GTD-5 switching system in Columbia did not have the capability to provide centrex-type services. As pointed out in the company's brief, there is no question that the Company chose to provide service to the University of Missouri through a DMS-100 rather than the GTD-5 because the proposed switch had the features available that would enable the Company to submit a competitive bid while the existing GTD-5 did not.

Seven bids were received in response to the University's REQUEST FOR PROPOSAL. Of those bids, four were technically acceptable and the sponsoring firms were invited to clarify and resubmit their bids. When the Company resubmitted its bid, the University's cost for regulated services would be $437,117 annually, a reduction of $176,333, as compared with the original proposal of $613,450 annually.

It is the Staff's contention that the existing switch would have adequately served the purposes of the non-University customers, and that no portion of the new switch should be allocated to those customers since it was installed solely for the purpose of providing centrex-type services to the University.

The switch in question serves 12,930 University lines. In addition, the switch serves 801 lines for six non-University CENTRANET customers and acts as a host for 7,513 lines serving eastern Columbia. Company's brief states the DMS-100 switch is clearly used and useful and is providing service to the Company's regulated ratepayers in Missouri. The statement is undoubtedly true but the Commission is of the opinion that the evidence establishes that the GTD-5 would have performed the same function. Company's brief also declares that it would be difficult to overstate the importance of retaining the University of Missouri as a customer of the Company's regulated services. That may well be. However, it was apparently not only difficult, but impossible, for the Company to justify the transferral of $176,333 from the first bid to the non-University customers in order to reduce the second bid. No cost-benefit analysis appears in this record. The Company's bald assertion of public benefit clearly does not meet its burden of proof. In the Commission's opinion, the Staff's proposed adjustment should be made.

Company witness Shellnutt defended the investment by saying "Installation of the DMS-100 in the Columbia area gave GTE North an excellent opportunity to provide some service protection for local customers." Shellnutt also defended the installation pointing out that in case of an outage to either switch, a portion of the City would retain service because of the two-switch configuration. In the Commission's opinion, the installation of such redundancy cannot be justified in the absence of some cost benefit analysis. The record is silent in this regard and the proposed disallowance and associated reduction of operating expenses should be effected for setting rates in this case.

2. EAX Switch

In 1975, GTE installed an AE No. 1 EAX (EAX) switch in the central office located in Columbia, Missouri. A depreciation account (Account No. 2211) was established to recover the cost of the switch over a 19-year period. The switch was expected to serve the Columbia office until 1994. In 1986, GTE retired the EAX switch early and replaced it with another switch which provided equal access and enhanced features. This early retirement left an undepreciated amount in Account No. 2211 of $2,597,000. GTE seeks recovery of this amount by amortization over a five-year period amounting to $519,000 annually. Also, GTE proposes that the unamortized investment remain in rate base until recovered.

The Commission's Staff and the Public Counsel oppose this recovery. Staff and Public Counsel argue that this approach would result in double recovery for Company since recovery of the current switch is also reflected in the depreciation rates being set in this case. Staff and Public Counsel do not oppose reflecting the cost of the current switch in the depreciation rates.

Staff further argues that the retirement of the EAX switch was premature and, as such, should not be reflected in the depreciation rates or in rate base. Staff asserts that Company's primary reason for retiring the EAX switch was to comply with an obligation to provide equal access placed upon GTE by the consent decree allowing GTE to purchase Southern Pacific Communications and Southern Pacific Satellite Company (now, US Sprint, hereinafter referred to as Sprint) whereby GTE entered the competitive long-distance market. Staff believes that the investment associated with the early retirement of the EAX switch should be treated as a cost of entering the interexchange market not to be reflected in the regulated Company's accounts.

Staff doubts Company's assertion that the replacement was made partly in the belief that equal access has become part of basic telecommunications service. Staff argues that, if Company's motive were to provide equal access for its customers in Columbia rather than to acquire the enhanced features of the current switch, Company would have chosen to upgrade the EAX system rather than replace the entire switch.

Staff and Public Counsel argue that replacing the EAX switch was uneconomical. Staff and Public Counsel assert that the study done by Company as to whether to replace or upgrade the EAX switch was biased toward replacement in that it did not account for the cost of recovering the reserve deficiency caused by the early retirement. Therefore, Public Counsel argues that Company's decision to replace the switch was imprudent and the cost of the uneconomical replacement should be borne by the shareholders and not the ratepayers.

Public Counsel further argues that the EAX switch should not be reflected in the depreciation rates and rate base because it is not presently used and useful. Public Counsel asserts that ratepayers should not pay for plant which does not benefit them.

The Company responds that it should not be penalized for its foresight and efficiency in skipping intermediate technologies by having to absorb the cost of retiring the EAX switch. Company explains that the EAX switch is the only asset in its Analog Electronics Switching Account (No. 2211) because GTE had bypassed crossbar and analog electronic technologies in going directly to digital technology from step-by-step technology in other central offices leaving only the Columbia switch. Company argues that under group accounting principles, the undepreciated investment in an asset that is retired before fully depreciated is depreciated through the remaining life rates applied to its group account. Company asserts that where, as here, there are no other assets in the account to which a remaining life rate can be applied, the unrecovered investment should be amortized.

Company points out that equal access has become part of basic telephone service and that its decision to achieve equal access through retirement of the EAX switch was reasonable and economical. Company defends its decision not to include some costs in its study evaluating replacement of the switch by stating that classic methodology requires that depreciation expenses not be treated as a cost when evaluating a retirement decision. Company states that such expenses are considered sunk costs which were made in the past and cannot be changed by current decisions.

Company responds that Public Counsel is wrong to suggest that the reserve deficiency associated with the EAX switch should not be recovered from ratepayers. Company argues that the EAX switch was used by its ratepayers for 11 years and that its recovery of the reserved deficiency associated with it is reasonable.

The Commission accepts the reasons and arguments advanced by the Company on this issue and believes that the loss the Company experienced as a result of the early retirement should be amortized as Company requests. The Commission is committed to the modernization of telephone plant and does not believe that Company should be penalized for its efforts to provide its ratepayers with the latest technology reasonably affordable. The EAX switch was used for 11 years before being retired. This length of service is within a reasonable range. Given the rapidity of technological advancement in the telecommunications industry, it is difficult to project with complete accuracy the life span of a given technology.

The Commission determines that the reserve deficiency associated with the EAX switch should be amortized over a five-year period. However, the Commission further determines that the unamortized investment should not remain in rate base until recovered. Since the EAX switch is no longer used and useful it should be removed from rate base since the ratepayers are receiving no benefit from it. This approach also avoids double recovery.

3. Capital Deployment

The Staff proposes to increase the Company's depreciation reserve on an intrastate basis by $4,498,000 and reduce the rate base by a like amount representing contended uneconomic decisions to replace items in six plant accounts. All are closely related to the Company's central office and network modernization plans and schedules for Missouri.

The Commission Staff employed a consultant to view processes used by the Company for deploying capital within its telecommunications network. It is the conclusion of the Staff's review that the Company is engaged in an aggressive network modernization program with a budget of $700,000,000 for local switch modernization and in excess of $1 billion for improvement of customer access facilities. Staff's report concludes that the tools used by Company are highly mechanistic and replete with opportunities for biased decisions and inaccuracies. No inaccuracies, however, are pointed out.

In addition, Staff's witness testified that he was not critical of the pace at which the Company was pursuing its modernization program. To the contrary, the only criticism revolves around the reasons given for the Company's modernization program. Staff criticizes the Company's replacement plans as being biased toward maximum profit instead of the most economical form of service. It is the contention of the Staff's consultant that the Company did not use enough alternatives in its computer model. Staff's consultant did not do a study of his own nor did he test the results of any of the criticized replacements by his own analysis.

The Company counters with what it considers to be several serious flaws in the Staff's criticism. Staff's proposed replacement schedules and recommended depreciation rates would extend the replacement schedules for electromechanical switching equipment until sometime between the first quarter of 2002 and the first quarter of 2005. Company's present schedule contemplates replacement of the last switch in that account in Missouri by 1999. The FCC has found that the Company's plan in Missouri is less aggressive than plans in other Company jurisdictions. Company points out that the amounts at issue listed by the Staff are on an entire Company basis, therefore, it appears the same schedule which the Staff contends to be aggressive is being pursued on a Company-wide basis.

The Company claims that the Staff consultant's analysis in this case is inconsistent with Staff witness testimony in the Company's last case, TC-87-57, on the issue of switch replacements. Staff's report in this case is critical of several switch replacements during the period of 1986 to 1988.

Company points out six of the offices replaced in that period use obsolete electromechanical relay equipment manufactured by Leich Electric Company. A Staff witness, in Case No. TC-87-57, stated that those switches have inherent design problems that make them unstable and unreliable and approved the Company's plans to replace the Leich switches. In this case, the Staff witness has admitted that replacement parts are no longer made for these switches and are generally unavailable. Of the remaining switches replaced between 1986 and 1988 seven were step-by-step electromechanical switches of which four were installed from 1958 to 1968.

In the Commission's opinion, there has been no showing by the Commission's Staff that the results of the Company's efforts are wrong. To the contrary, it appears that Company's efforts have been to improve the quality of service and to enhance the communications capability of its system. As technology advances, the Company has an obligation to bring state-of-the-art services to its customers as quickly as is reasonably and affordably practical, including equal access capability and custom calling features. That is what Company's capital deployment model is designed to achieve.

In the recent Southwestern Bell complaint, TC-89-14, the Commission expressed the belief that network modernization should proceed based upon economic as well as noneconomic factors. In that case the Commission made no adjustment to Southwestern Bell's revenue requirement for costs associated with digital replacements at issue. We are of the opinion that that encouragement should apply equally to GTE. We restate our desire to see network modernization proceed.

In the Commission's opinion customers of the Company are equally interested in modernization. That belief is to some extent illustrated by testimony of the City Administrator of Macon at the hearing in this matter held in Columbia, Missouri. The City Administrator expressed dissatisfaction with the level of service being rendered to his town of 6,000 because it did not have a digital system. The City Administrator felt especially disappointed by the fact that the City of Bevier, about five miles distant, and with a population of approximately 600, was served by a digital system by a much smaller company. It was pointed out in the Company's brief that that type of customer dissatisfaction could not be included in a computer study. The modernization program, influenced by judgment, should be substantially instrumental in reducing such customer dissatisfaction.

The Company has used an extensive study as the basis of its network planning. In the absence of a showing that the results of the program are wrong Company's efforts at network modernization should not be hindered because of perceived flaws in the nature of the inputs to a computer model. Staff's proposed disallowance is rejected.

4. <u>Cash Working Capital</u>

There is no dispute between the parties that the Company's rate base should include reasonable amounts of cash working capital to allow the Company to pay its day-to-day expenses incurred in the provision of service for which it has not yet received payment. Company seeks an inclusion of $2,181,000 of cash working capital whereas the Staff proposes a negative cash working capital of $1,059,000.

One of the areas of disagreement concerns the Staff's exclusion of depreciation and amortization, deferred taxes, and return on common equity. The Commission has a long history of excluding from cash working capital the enumerated items because, while they may be recorded on the Company's books, the accounts do not require any cash for current outlay. Since there is no requirement of cash outlay, the items do not fall within the definition of cash working capital and there is no more persuasive reason for their inclusion than there has been in many instances in the past when the items have been excluded. There is also a dispute between the parties as to the proper collection lag to be used in lead/lag studies. In its lead/lag study the Company used three non-consecutive months and included both the current and the previous month's billing compared with only the current month's receipts. As such, the Company's method did not properly match the billings and receipts resulting in an overstatement of the Company's collection lag.

For its collection lag, the Staff used a customer sample developed in the Company's last rate case. Staff's 17.9 day collection lag would fall within 21 days prescribed by the Commission's rules as well as the Company's tariffs for payment of residential bills. The Company's tariffs allow business customers 15 days to pay their telephone bills. Company's asserted lag of 31.42 days indicates that the average customer pays his bills at least ten days late. Such a condition appears highly unlikely. The Commission finds that the Staff's collection lag is more consistent with reality.

The controversy concerning the lag days associated with certain expenses is the Company's payments for switched access or private line expenses. Company's due date for the expenses associated with switched access of private line expenses are 73.27 days and 74.35 days, respectively. Company actually pays for these expenses 65.71 days and 60.85 days, respectively. In the Commission's opinion, the Staff is correct in assuming that it may be imprudent for the Company to pay its bills prior to the time they are due. Company's choice to pay its bills early should not result in an additional inclusion for cash working capital. The Staff's negative cash working capital should be adopted for the purposes of this case.

5. Short-Term Telephone Plant Under Construction (TPUC)

Company proposes to include in rate base construction to be completed in one year or less in the amount of $2,139,000. Company contends the inclusion is reasonable because (1) the amount is known and measurable, (2) benefits of the construction will be realized in the very near future, and (3) the inclusion would increase internally generated funds available to finance construction, thus lowering interest costs.

The Staff opposes the inclusion because the plant is not operational and is neither used nor useful in providing service. It is the Staff's position that since current ratepayers receive no benefit, a return on plant should be provided by future ratepayers. Staff also suggests that the proposed inclusion fails to consider increased revenues and reduced maintenance costs to be occasioned by the completion of the projects under construction.

Finally, it is pointed out by the Staff that the Commission has a long history of disallowing TPUC from inclusion in rate base. The Commission has, consistently, disallowed construction in progress from rate base because the involved projects are not considered "in service." There has been no evidence offered in the instant record on which we could base a departure from our traditional disallowance based on the relatively simple concept which is analogous to asking customers to pay before the doors of the store are open.

Because of its desire to see modernization proceed, the Commission may be willing to reexamine its traditional position on TPUC in an appropriate case. In the instant case, however, the Company's position is flawed in two respects which would not permit an alteration of customary disallowance. As pointed out in the Staff's brief, there could be a strong argument in favor of the determination that Company already has plant in service which exceeds necessary capacity. Under those circumstances present ratepayers would be asked to increase the amount of return they are providing on unnecessary plant. The second flaw in the Company's proposal is Company's current difficulty in completing its short-term construction projects with one year due to project cancellation and delays. To counteract that flaw, the Commission would need specific evidence that only an insignificant amount of TPUC is in that category. The proposal also may be flawed to some extent because it fails to consider the benefits of increased revenues generated by the completion of the construction projects. In this case, short-term TPUC will not be included in rate base.

6. Separation Factors

The Company proposes to increase its intrastate rate base by using what it claims are the latest known separation factors as of January 1, 1989. The Staff, by the use of actual 1988 separation factors, proposes to reduce the Company's rate base by $1,176,000. As a result, the Staff also proposes to reduce the expense portion of the adjustment by $522,000 annually.

The separation factors used by the Staff were provided by the Company in response to a data request. The Staff also calculated the Company's revenue requirement based on known separation factors at the end of July, 1989. The use of those more current separation factors changed the revenue requirement for the Company ranging from a reduction of $73,000 to an increase of $56,000 over actual 1988 data. The Staff also used separation factors based on the inverse of the Tariffs Review Plan filed with the Federal Communications Commission December 31, 1988. Comparisons of the actual 1988 factors and the annualized factors through June, 1988, indicate that the factors filed in the Tariff Review Plan are more accurate than the Company's filing made in this case. In the Commission's opinion it is logical to use the inverse of the filed Tariff Review Plan factors that relate to the interstate jurisdiction as they logically represent the factors which relate to the remaining intrastate jurisdiction.

The Company used factors which contain the effects of known changes and the effects of proposed changes within the Missouri study area of the Company.

In the Commission's opinion, the Staff's method of determining separations is more reasonable than the Company's which includes projected data. Staff's separations calculation should be adopted and the proposed adjustments should be placed into effect.

7. Banked Vacation Expense

The Commission Staff proposes to deduct from the Company's rate base banked vacation expense in the amount of $197,000.

Company has a program under which management employees with 15 years of service earning four weeks of vacation may bank, or defer taking, one week of that vacation. Eligible employees receive their regular pay regardless of whether they elect to use all of their vacation or bank part of it. Company books the banked vacation expense as a current liability because it is a liability which may come due within one year.

In Staff's opinion the amounts associated with banked vacation expense should not be considered a current liability, but should be deducted from rate base because the Company has use of such funds for an extended period of time well in advance of payment to its employees. This is alleged to be true since eligible employees may defer the banked vacation indefinitely and take it in a lump sum payment. It is the Staff's contention that, if such amounts are not deducted from rate base, the result is that current ratepayers receiving no benefit from the banked vacation expense would be paying for that banked vacation.

In the Commission's opinion, the Staff's adjustment is flawed and should be rejected for two reasons. The Staff's analysis does not reflect the amount of banked vacation expense pertaining to 1988. Instead, the amount developed by the Staff is accumulated untaken vacation banked by the Company's employees.

In addition, the Company expenses the item at the time banked. It is true that an employee who works during part of his vacation will earn his entire pay in addition to the banked vacation. Although the current ratepayers pay the additional wage expense, the current ratepayers are also receiving the additional labor productivity. A current benefit is received by the ratepayers concurrently with the liability being established. The Commission finds this to be a proper matching of current productivity with current expense.

V. REVENUES

1. Annualization

Both Staff and Company agree on the propriety of stating revenues on an end-of-the-test-year basis. Staff and the Company disagree as to the reasonableness of the amount of estimated revenues for the period during which the rates to be set in this case will be in effect. The Staff proposes to increase the Company's intrastate revenues by $2,335,000 whereas the Company's proposed increase is $1,072,000.

For the Staff's annualization it examined the Company's revenue accounts from December, 1983, through June, 1989, to establish any trends on a going forward basis. Trends were then used to annualize 1988 test year revenues. Although the Company criticizes the Staff's method as being a variation in technique, the Staff's calculations were developed to capture the unique trends in each of the accounts.

Where no trend was discerned in an account no adjustment was made. By the establishment of the discerned trend the Staff increased the Company's levels of uncollectible revenues, an advantage to the Company. As a check the

Staff then compared the levels of revenues at June, 1989 to verify the results of their 1988 annualization.

The Company is critical of the Staff's method also as a result of the Company's presentation of their actual level of revenues as of September, 1989 annualized. It is pointed out by the Company that the Staff revenue adjustment for 1988 has resulted in the Staff stating the level of revenues approximately $400,000 above the level experienced by the Company nine months after the end of the test year. As pointed out in the Staff's reply brief, the Company's 1988 annualization understated September, 1989 annualized actual revenues by $1,178,000 on the basis of the issues settled at the prehearing conference.

The revenue annualization that the Company asks us to accept was based partly on only five months of data from August to December, 1988. An additional portion of the Company's annualization consisted of developing the percentage of growth in switched access lines for 1988 over 1987. The Company used half of that 2.89 percent to arrive at an annual growth rate assuming that growth occurs evenly. As the Staff has observed, that annualization factor only reflects the number of customers for basic local network service which is only a portion of all local network service revenues. The Staff's analysis shows that individual accounts should reflect a much higher percentage of increase. As an example, the actual increase in the billable units for custom calling for 1988 was 34.75 percent above that of 1987.

It should be observed that both of the methods are estimates only. It is true that the Staff's annualization of revenues estimates the Company's revenues to be above that actually experienced in 1989. By the same token, the margin of error in the Company's estimate is substantially higher. It should also be borne in mind that the rates to be set in this case are not for 1989, but are for a portion of 1990 and beyond. Since the Staff's revenue annualization estimate was more consistent with reality than that of the Company's it should be adopted for the purposes of this case.

2. Reduction In Carrier Common Line Charge (CCLC)

As a part of its revenue requirement Company proposes to reflect reduction in access revenues of $324,000 resulting from the Commission's order issued May 19, 1989, in an AT&T complaint Case No. TC-89-28.

The Staff opposes the inclusion because it is a post test year adjustment although it is now known and measurable. Staff also objects to the amount requested by the Company because it was not covered in the Company's direct case filed on March 23, 1989. It is the Staff's position that the Company should have included the amount in its original case since the pendency of the complaint was known and an adverse effect should have been provided for.

The Company, on March 23, 1989, filed supplemental direct testimony concerning the reduction in CCLC as soon as practical after being aware of the decision.

The Company defends the inclusion because the reduction in CCLC was not known and measurable at the time of the original filing. The Company feels that it had a meritorious defense and should not have anticipated losing the complaint case. Company further objects to being second guessed for not exhibiting a weakness in the complaint case by proposing a rate case adjustment to account for the loss.

In the Commission's opinion the Company's position has merit and the adjustment for reduction in CCLC should be authorized.

VI. OPERATING EXPENSES

1. The Annualization Of Expenses

Company proposes to adjust and increase its intrastate operating expenses, other than wages, by an amount of $403,000. As previously discussed in the revenue section, the Company increased a number of expense categories by 1.45 percent based upon a half-year effect of the growth in access lines for 1988 over 1987. Several other categories of expenses are proposed to be increased by one-half of the inflation rate of 4.4 percent for 1988 as established by a consumer price index. In the Commission's opinion the Company's expense estimate is unrealiable and should be rejected. The Company witness did not know either the current rate of inflation or the current rate of increase in access lines. No study has been performed to show that the involved expenses increase is in direct relation to those indices.

In the recent Southwestern Bell complaint case, TC-89-14, we rejected the use of an index to set rates because a consumer price index is not directly related to the Company's expenses and is not related to Company's specific information. As a general rule rates should not be set by rule of thumb or formula. The use of a customer price index violates that general prohibition.

In the Commission's opinion the Staff's estimate of expenses is more reasonable as being more closely related to what is actually happening to the Company. The Company is proposing to set future rates based on a past index. There is no evidence in the record to establish that the past consumer price index is even remotely related to what the consumer price index will be in the future. As such, the Company's proposed method is too speculative to be used as any reasonable estimate of future expenses.

The Staff's evidence recognizes that the Company's expenses for 1989 appear to be increasing over those of 1988. A portion of the increase for the first six months of 1989 is largely the result of the implemention of the primary toll carrier plan on July 1, 1988, and the additional access charge expense resulting therefrom.

The Company's proposed increase is an estimation not based on a sufficiently sound analysis to be adopted for purposes of this case.

2. Winning Connection II (WC II)

WC II is a substantial reorganization of the Company under which the seven individual telephone operating companies are to be consolidated into four areas of operation. It is expected by the Company that WC II will result in substantial savings. During the 1988 test year, the Company has estimated that it will incur costs of implementing WC II in the amount of $150,000 during 1989, and commencing in 1990, the Company will start to realize savings.

Although the Commission Staff did not originally propose an adjustment for savings of WC II, the Staff now proposes such an adjustment in the event that the Commission adopts the Company's position on the reduction of CCLC and rate case expense. In effect, the Staff is asking to make an out-of-period adjustment in the event that the Commission adopts the Company's position on what the Staff claims to be to other out-of-period adjustments.

The Company has not proposed to include any of the 1990 costs in this case because of the perceived uncertainty of the amount. By the same token, the Company contends that savings of WC II, commencing in 1990, are merely estimates and, although they qualify as known events, they are certainly far from measurable.

It is the Company's contention that if the Commission adopts an incentive regulation plan for the Company commencing in 1990, the Company will have absorbed the costs of WC II in 1989 and ratepayers will have the opportunity to share in the savings for 1990 and beyond.

In the Commission's opinion, the Company's position should be accepted and the proposed Staff adjustment cannot be made. Issues of WC II, CCLC and rate case expense are in no way similar and should not be considered interdependent or a part of a package. In addition, the effects of WC II are not certain enough to be included. The effects of WC II on the Company's expenses are still in the future at the time of the issuance of this order and two years in the future from the test period.

3. Uniform System Of Accounts (USOA), Part 32

The Commission Staff proposes to shift $725,000 in intrastate expenses, associated with the adoption of the revised USOA Part 32, to construction and thus be capitalized for ratemaking purposes.

Part 31 of the USOA was adopted in 1934, providing for investment, revenues and expenses in a heavily regulated telephone industry which provided end-to-end service without competition. The recent adoption of Part 32 of the USOA as a replacement is in response to the recognition of the existence of competition.

Although the Commission has adopted Part 32 for accounting purposes, the Staff proposes that Part 31 be used for ratemaking purposes for the accounts of (1) software, (2) general overheads, (3) motor vehicle depreciation, (4) data processing, (5) insurance, (6) meetings and budget analysis, and (7) operational training.

In the recent Southwestern Bell Telephone case the Commission Staff proposed a much wider continued use of Part 31 for ratemaking purposes. The Commission in that case rejected the Staff's position. In the instant case, the Staff is proposing a much narrower application of Part 31 for ratemaking.

The Staff is of the opinion that any criticism of its position in the Southwestern Bell case has been eliminated by proposing to capitalize only items that meet the following criteria: (1) Was the item necessary and beneficial to the Company's construction program? and (2) Did the Company's construction program increase the level of the cost of this item to the Company? It is the

Staff's contention that failure to adopt its position would result in current ratepayers paying the costs associated with benefits that will be received by future ratepayers.

The Company objects to the Staff's proposal for a number of reasons. The Company listed several areas where a great amount of diffulty would be encountered in assigning certain costs to particular projects. One example is the conduct of construction meetings or occupational training wherein safety and related items may be discussed which are equally applicable to construction and current maintenance. A number of the accounts would require annual studies to determine the proper distrbution of expenses, and all of the accounts would require the maintenance of side records which would be purely a Missouri expense since it would be of no value in the nine other States in which the Company operates. The side records would also be of no benefit to the Federal Communications Commission. The Commission agrees with these objections to Staff's proposal. The Commission is also of the opinion that the increased costs for the studies and side records would themselves have to be allocated in an annual study of the studies.

Finally, the Staff's argument overlooks the fact that, to a large extent, present and future ratepayers of the Company are largely overlapping groups. We are of the opinion that there has been an insufficient showing of enough benefit to justify the incurring of additional costs to precisely distribute present and future expenses to substantially the same group of people. Since the adjustment is not adequately supported, the proposed shift of $725,000 to capitalization should be rejected. Part 32 should be adopted for ratemaking purposes for GTE North.

4. Separation Factors

For the reasons discussed in this Report and Order at section IV. 6, Staff's proposed reduction of intrastate expenses by $522,000 annually should be adopted.

5. Management Incentive Plan

The Commission Staff proposes to disallow the Missouri intrastate portion of three management incentive plans in the amount of $42,000. The executive incentive plans apply to executives of GTE North and two affiliates. Staff estimated the Missouri portion of the costs by applying a 2.92 percent factor to GTE North costs, a .67 percent factor to one subsidiary and a .335 percent factor to the second subsidiary.

The Unit Incentive Plan (UIP) is designed to provide key executives and managers with additional incentives to achieve excellence in management through financial rewards based upon achievements of predetermined business directives. The Executive Incentive Plan (GIP), at least in part, is designed to promote the achievement of year-to-year financial and other business objectives such as high quality of service and products. A Long-Term Incentive Plan (LTIP) is intended in part to aid in attracting and retaining key officers and other employees of outstanding abilities in specialized skills.

The Staff proposes to eliminate these costs because they result in payments allocated to Missouri which are based on non-Missouri results, emphasize net income as a high priority, include certain objectives that actually are to the customer's disadvantage, do not result in any measurable increase in productivity or efficiency, are not based on GTE-Mo's related performance, and do not monitor the performance of those who are the recipients of the incentives. One of the specific criticisms of the plan is that a portion of the plan's evaluation is based on customer perceptions derived from opinion surveys. Another specific criticism is that a participant can receive a partial payout for reaching only 50 percent of said expectations.

The Company's testimony establishes that its salaries are set below the market and that a portion of what would be considered a normal salary is put at risk and must be reearned every year. There has been no contention by the Staff that the resultant salaries are too high or that any person is being overpaid. Since there is no contention that the result is flawed the Commission is of the opinion that potential errors should not weigh heavily against the plan. The amount at issue is only a small portion of the Company-wide payments and two of the plans only involve one person each in the State of Missouri. We are of the opinion that an insufficient number of valid criticisms have been raised to discourage the use of the Company's incentive plans and the proposed adjustment should be rejected.

In considering a similar issue in the recent Bell complaint, we rejected a proposed disallowance because we were unable to find that the total compensation level is excessive or that the awards were not reasonably calculated to encourage Company-wide performance. In Re: Southwestern Bell, TC-89-14, et al., 29 Mo. P.S.C.(N.S.) 605 (1989). In the Commission's opinion, similar to the facts in the Bell case, the benefits of the plan are reasonably ascertainable and sufficiently related to Missouri to be included. As we had previously expressed in Staff v. Union Electric Company, 29 Mo. P.S.C. (N.S.) 605 (1989), 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. We find those conditions to exist here and the result should be in harmony with the Bell and Union Electric cases.

6. Rate Case Expense

The Commission Staff proposes to disallow what the Staff preceives to be an untimely request for rate case expense on the part of the Company. Staff proposes this disallowance because the request was not contained in the Company's original filing but was sought in supplemental direct testimony filed on August 22, 1989. Staff further requests its rejection because the expense is outside the test year and is being incurred for an unnecessary rate case. Finally, the Staff contends that rate case expense should not be allowed since it is being more than offset by the savings from WC-II which the Company is not proposing to recognize in this case.

The Company's testimony indicates that it initially had made the decision not to ask for an inclusion of rate case expense. On realizing that the cost of the Staff's audit was higher than anticipated, the Company's management decided to ask for the actual cost of the audit and the Staff's outside consulting witnesses in this matter. As a result, the Company is not asking for the costs it would normally incur in a rate case but is seeking $64,000 of direct costs amortized over three years for an annual amount of $21,000.

In the Commission's opinion rate case expense should not be disallowed as being in violation of the Commission's initial filing rules or as an out-of-period adjustment. The Company has asked only for the direct out-of-pocket expenses associated with the Staff's case and has requested those items as soon as they have become known and measurable. Rate case expense is commonly allowed in similar proceedings. The reasons offered for the disallowance are inadequate to alter the customary result. Request for rate case expense was included in the Company's filing as early as the amount could be determined and in sufficient time that no one has been confronted with a suprise issue.

VII. AFFILIATED TRANSACTIONS

1. Directory Advertising Retention Rate

GTE North has contracted with GTE Directories for the publishing of white and yellow page directories. GTE Directories publishes all of GTE North's white and yellow page directories except for GTE North's operations in Minnesota. Under the current contract, entered into in 1984, GTE North retains 48 percent of the gross directory revenues billed, as adjusted for a revenue loss allowance. GTE Directories then receives the reciprocal percentage of revenues, 62 percent.

Staff has proposed that GTE North retain 61.4 percent for its Missouri operations rather than the 48 percent in the current contract. It is Staff's position that GTE North has provided no support for the 48 percent retention rate for its Missouri operations and that 61.4 percent was the retention rate proposed by General Telephone Company of the Midwest (GTMW), a GTE North predecessor, in 1984. The 61.4 percent was the goal for GTMW in its negotiations with GTE Directories. The 61.4 percent was based upon an 83 percent payout ratio for total domestic telephone companies plus nonaffiliated telephone companies income and other income items for 1981.

The evidence concerning the relationship between GTE Directories and GTE North and its predecessors indicates that no real negotiations have occurred. Neither GTE North nor GTE Directories could provide any documentation or explanation of how the 48 percent retention rate was arrived at through negotiations. GTE North did present evidence from a GTE Directories witness that explained how retention rates might be set, but there was no evidence these criteria were used during the negotiations in 1984.

The evidence indicates that instead of negotiations, GTMW received the 48 percent retention rate, which had been in existence for many years prior to 1984. The 1984 contract has since been renewed once and is now renewed on a month to month basis. There was no evidence of negotiations since 1984 and GTE North did not present a witness to explain why it is continuing the contract with the 1984 retention rate.

There was evidence comparing the retention rates of Hawaii, Texas and Missouri. This evidence, though, carries little weight in establishing what the retention rate should be in Missouri. The comparison indicates that the Hawaii market is unique and that the Texas market is ten times that of Missouri. The Commission finds that the operations in Hawaii and Texas are not sufficiently comparable to Missouri operations to provide any guidance on what the Missouri retention rate should be.

Evidence was introduced showing the retention rates for other GTE telephone operations. This evidence provides little guidance, by itself, in determining what the retention rate in Missouri should be. To compare operations in different states, there must be some comparison of geodemographics.

GTE North does not keep state-specific data on directory expenses. Staff could therefore not update the 1983 payout ratio and retention rate using the same calculations as GTMW did in proposing its goal of 61.4 percent. Staff did calculate a payout ratio for 1987 and 1988 of from 81.2 percent to 87.5 percent using other data. This indicates the payout ratio is still comparable to the 83 percent calculated in 1983.

The 48 percent retention rate has been in existence for 20 years. No evidence was adduced by GTE North concerning the acceptance of a 48 percent retention rate in 1984 or since. The Commission finds that the 48 percent retention rate is not reasonable. GTE North does not competitively bid its directory requirements but, instead, contracts with an affiliate for these services. There appears to have been little or no negotiation over the rate. If there were arm's-length negotiations, there should be some deviation in the rate over a 20-year period or some evidence from GTE North of the benefits received for retaining the 48 percent rate. There was evidence of some concessions that GTE Directories made in 1984 but these were not quantified, nor were they shown to have any influence on the retention rate.

GTE North has the burden of showing that the revenues received from its directory services are reasonable. Missouri ratepayers should not be paying higher rates to subsidize an affiliate's profit. The evidence is that GTE Directories' return is substantially higher than that found reasonable for GTE North in this case. Without evidence from GTE North supporting the 48 percent rate and why it was accepted, there is no evidence to support the 48 percent rate and the Commission therefore finds the rate is not reasonable.

Since the 48 percent retention rate has been found to be unreasonable, the only other evidence of a reasonable rate is the one proposed by GTMW in 1983. Although it could be argued that the 61.4 percent rate would not have been the final negotiated rate, there was a reasonable basis for establishing the rate since it was developed by GTMW and was based upon the payout ratio for the total GTE domestic telephone companies plus nonaffiliated telephone companies and other income items of 83 percent. This payout ratio is comparable to 1987 and 1988 payout ratios. Based upon this evidence, the Commission finds the 61.4 percent retention rate is reasonable. GTE North's revenue requirement will be adjusted $512,000 as proposed by Staff.

2. GTE Telecom Marketing Corporation

GTE Telecom Marketing Corporation (GTE TMC) is Company's marketing arm to multiline business customers. The Staff proposed to decrease this expense by $173,000 to reduce the amount of distributor commission paid to GTE TMC to reflect a 20 percent operating margin. The Staff also contended that the 50 percent commission factor used in calculating Company's costs is unreasonable. The Staff asserted that the charges billed to Company by GTE TMC included an exorbitant profit.

The Company opposed the Staff's adjustment contending there was no margin and its use of a 50 percent commission factor had not been successfully challenged by the Staff as unreasonable.

The "profit" margin to which Staff referred and the Company denied is the level of contribution Company pays to GTE TMC's common costs. The Company was technically correct when it stated it is billed by GTE TMC at cost only. The question is whether Company's contribution to GTE TMC's common costs covers costs unrelated to Company's regulated activities. This is the point at issue when Staff challenges the 50 percent commission factor. The recovery of costs unrelated to Company's regulated activities is the "exorbitant" profit identified by the Staff.

The Staff determined the level of operating margin that would contain such profit to be 20 percent by using the level of operating margin targeted by the GTE Telephone Operating Group Strategic Plan. The record provides no documentation as to the appropriateness of this percentage figure as used by the telephone group or the Staff. Therefore, its use by this Commission would be arbitrary.

The Staff contended the 50 percent commission factor was unreasonable because of an internal memo and a consulting firm's findings that profitability was a critical issue. Thus, Staff witness Boltz stated it appeared to him that a GTE TMC employee would be spending more than half of his time on the nonprofitable line of deregulated business. There is nothing in the record that substantiates this speculation.

The issue is the proper allocation of costs. Upon the record of this case, the Commission cannot conclude that Company's TMC expense is unreasonable. Therefore, Staff's proposed adjustment will be rejected.

However, the Commission will require the Company to provide clearly documented support for its cost allocations in the next proceeding or risk disallowance of the entire expense.

3. <u>GTE Data Services</u>

GTE Data Services (GTEDS) supplies data processing services to GTE telephone operating companies, including the Company. The Staff contended such services should be provided in-house at cost only. To eliminate the profit Company must pay on charges incurred because the services are performed externally, Staff proposed to reduce Company's expenses by $180,000. The Company opposed such an adjustment and contended the Commission should consider the reasonableness of the prices charged by GTEDS.

The concerns expressed by the Staff are based on the affiliate relationship between Company and GTEDS and that that relationship may cause the existence of profit to be a function of cost of service manipulation. However, there is no statute or Commission policy prohibiting the recovery of reasonable profit made on affiliated transactions.

The Company has offered evidence, which the Staff did not dispute, that prices charged by GTEDS to Company are the prices charged for similar services by other vendors in the marketplace and that the prices charged are also equal to or less than prices charged either to other GTE affiliates or to nonaffiliated third parties. There is no disagreement as to the reasonableness of the prices charged by GTEDS. That there were inefficiencies in the system is moot because steps have been taken to remove them. Moreover, the record does not show that the provision of data processing services in-house would have been more efficient or that such inefficiencies contributed to the price of the services.

Because of undisputed evidence that prices charged to Company by GTEDS were favorable in comparison to other vendors and were at or below prices charged to other GTE affiliates and nonaffiliated third parties, and the lack of evidence that data processing could be done more efficiently or less costly in-house, the Commission finds it must reject Staff's adjustment and accept the Company's expense figure as proposed.

VIII. DEPRECIATION AND AMORTIZATION EXPENSE

1. Prescription of Depreciation Rates

The primary matter at issue herein is the basis for establishing the depreciation rates. Staff and Company no longer disagree as to the plant levels to which the rates should apply. These parties request that the Commission prescribe rates effective January 1, 1990, which would apply to plant balances as of December 31, 1988. Also, Company and Staff use the same method in calculating the depreciation rates.

Staff proposes depreciation rates using historical data as the basis for estimating the life expectancy of plant in the accounts at issue. (These are the accounts listed in Appendix B attached to the Hearing Memorandum.) Company proposes depreciation rates which reflect, to some degree, the life expectancy of plant which Company expects to place in service in the future.

Staff opposes this approach as speculative. Company supports this approach primarily on the basis that it fosters modernization.

The Commission determines that Company has provided no basis for deviating from the usual historical approach. In this Report and Order the Commission has demonstrated its support for modernization. However, in these accounts, the Company specified no modernization schedule but rather made vague references to the effect of technological change upon the life expectancy in certain accounts. Indeed, most of the accounts at issue herein have no relevancy to modernization. Concerning those accounts relevant to modernization, the Company has not met its burden to show that accelerated depreciation is needed.

The Commission recognizes that as new technologies are developed and deployed, depreciation schedules may need to be accelerated to encourage reasonable modernization. The record in this case is too speculative to give the Commission a sound factual or theoretical basis for accelerating the depreciation rate in specific accounts. The Commission would need data or a meaningful theoretical model upon which to base a decision to accelerate depreciation schedules. In the absence of such information the Commission determines that the historical approach proposed by Staff should be used to set Company's depreciation rates.

2. Amortization Of Reserve Deficiency

See Section IV 2.

3. Capital Deployment Depreciation Rates Overlay

The Commission has not adopted Staff's Capital Deployment Study or the depreciation accrual rates therein proposed. As a result, this issue and Staff's originally proposed accrual rates for plant accounts 2215, 2232, 2421, 2422 and 2423, is no longer contested.

IX. INCOME TAX

1. Tax Impact of "Double Leverage"

The only contested income tax issue is the calculation of the Company's interest expense. Staff proposes a method of computing interest expense which, on Staff's proposed rate base, produces $3,408,000. Company, using its proposed rate base and a different method of calculation, claims interest expense of $2,952,000. The issue cannot be resolved by using the actual amount of interest expense claimed by the Company, inasmuch as GTE North does not file an individual income tax return. As a wholly-owned subsidiary of the GTE Corporation, GTE North's income taxes are paid by its parent, via a consolidated return. Staff's proposed "double leverage" treatment of GTE North's income tax expense derives from this association of parent and subsidiary, whereby the parent's long and short-term debt is used as a component in calculating GTE North's interest expense. The Company proposes that only its debt be taken into account to calculate interest expense.

The different approaches in calculating interest expense affects revenues, and rates, as follows: the higher a company's interest expense, the less tax it has to pay; the less tax it has to pay, the lower its revenue requirement. The revenue effect of Staff's proposed adjustment in this case, using Staff's rate base, is $300,000. Thus, accepting Staff's method of computing interest expense will reduce the Company's revenue requirement by that amount.

Expressed as a percentage of rate base, Staff proposes that the parent GTE Corporation's cost of long and short-term debt, 2.5 percent, should be multiplied by GTE North's equity component of 57.80 percent. This produces a weighted cost of debt for the parent of 1.45 percent. Adding the parent's weighted cost of debt to GTE North's weighted cost of debt produces the double leveraged calculation of 4.8 percent, the multiplier which, when applied to rate base, produces the income tax adjustment sought by Staff. The Company, utilizing only the long and short-term debt of GTE North, proposes a multiplier of 3.35 percent.

Staff and Public Counsel maintain that taking the debt component of GTE Corporation into account is required to arrive at a true statement of interest expense for GTE Corporation's subsidiary, GTE North. The Commission agrees. When a consolidated tax return is filed, as here, income tax liability is determined on a system-wide basis, that is, by looking to income and expense in the entire corporate family. Thus, the interest expense on GTE Corporation's long and short-term debt will lower not only the tax liability of the GTE Corporation, but that of its subsidiaries, including GTE North.

Having filed no tax return, GTE North's interest expense is used by its parent in the parent's consolidated tax return. Staff's double-leverage adjustment, by factoring the parent's debt, reflects this co-mingling of parent and subsidiary interest expense in the parent's consolidated tax return.

With the approval of the courts, the Commission has employed double leverage adjustments to arrive at return on equity for wholly-owned subsidiaries. State ex rel. Associated Natural Gas Company vs. Public Service Commission of Missouri, 706 S.W.2d 870, 876-79 (Mo. App. 1985). The Commission has found, and finds in this case, that only by taking the parent's debt into account can a true picture of the subsidiary's revenue requirement emerge.

X. COST OF COMMON EQUITY AND RETURN ON RATE BASE

1. Settled Issues

Cost of capital testimony was offered by the Company and the Commission Staff. As a result of the prehearing conference the parties have agreed on the capital structure of both GTE and GTE North. The only real disagreement between the Company and Staff concerns the appropriate rate of return on common equity which GTE North should be given an opportunity to earn. It is also agreed by the parties that a reasonable estimate of the cost of GTE North's common equity must be performed since Company's stock is not publicly traded. The estimates result in a recommended range of 11.51 percent to 12.64 percent by the Staff and 13.7 percent by the Company.

2. Staff's Recommendation

Staff witness Kemp first employed a constant growth, infinite horizon discounted cash flow (DCF) calculation to arrive at a range of equity costs for GTE of 13.5 to 14.5 percent. The traditional DCF model employed by the Staff assumes that the present price of the Company's stock is valued upon expected cash dividends and increases in future prices. The rate required to discount expected cash flows and the present price of the stock is the required cost of equity. The cost of equity is equal to the current dividend divided by the current price of the stock plus an appropriate growth rate.

Kemp studied dividend yields for GTE from January, 1987 to August, 1989. Since the yield has declined since September, 1988, Kemp employed the yields occurring during June, July and August, 1989, resulting in a five percent figure which was included in the dividend yield portion of the DCF model.

For the growth rate, Kemp employed projections by 12 analysts in a monthly publication entitled: Institutional Brokers Estimate System (IBES) and the projection contained in the Value Line Investment Survey of July 21, 1989. Giving equal weight to the 13 estimates resulted in an average earnings growth rate for GTE of 9.12 percent.

Kemp also studied GTE's dividends per share growth rate and Value Line estimates calculated during the period 1986 through 1988 and the future periods of 1990 to 1994. The compound interest growth rate was estimated at 7.76 percent. A study was also performed of a three-year projected dividend per share growth rate by Standard and Poor's of seven to nine percent to arrive at an average dividend growth figure of 8.88 percent. Since the resulting nine percent figure was a composite of a range of growth rates Kemp determined that a growth rate range for the DCF model of 8.5 to 9.5 percent was appropriate.

The traditional DCF formula of (D/P) plus G results in a range of 13.5 to 14.5 percent recommended return for the equity of GTE.

Since the stock of GTE North is held by GTE, Kemp felt it appropriate to make a double leverage adjustment. The term "double leverage" is used to describe a situation involving a holding company in which debt capital is raised at both the subsidiary and the parent company levels. Since there are two levels of debt there are two levels of leveraging. Kemp felt it improper to use the common equity cost of GTE in the calculation because the holding company's operations include both regulated and nonregulated companies. GTE's revenues consist of approximately 61.99 percent from regulated telephone companies and 38.01 percent from nonregulated activities. Kemp attempted to "residually" determine a cost of equity for the regulated telephone operations by calculating a reasonable rate of return for the more risky nonregulated operations. Nonregulated operations were perceived to be riskier since GTE has a bond rating of A-3 whereas GTE North's is the higher A-a3. Also, GTE has a borrowing capacity of prime 2 whereas GTE North's rating is a higher prime 1.

To conduct his estimate of the cost of capital for the nonregulated subsidiaries Kemp reviewed the dividends of all of the Standard and Poor's 400 industrial companies. Kemp selected the 117 of the companies with a below average risk in what he perceived to be an effort to be conservative. Using a traditional DCF, Kemp arrived at an estimated rate of return on equity for the nonregulated companies of 15.5 to 16.7 percent. Again in an effort to be conservative, Kemp used the low end. By making an analysis of the respective revenues of the regulated and nonregulated companies he arrived at a residual rate of return for the regulated companies of 12.27 to 13.89 percent. To check, Kemp compared that amount with a DCF analysis on regulated telephone companies, including four independents and seven regional Bell companies. The range for those companies was from 11.79 percent to 11.97 percent. By the use of the double leverage calculation Kemp arrived at his suggested rate of return on common equity for GTE North of 11.51 percent to 12.64 percent.

3. Company's Recommendation

The Company's revised recommended cost of equity was arrived at by giving 50 percent weight to two separate DCF analyses, one a constant growth infinite horizon model and the other a finite horizon model. The Company also gave 50 percent weight to a risk premium analysis. The Company witness also performed a DCF and risk premium analysis for a proxy group of gas distribution companies. As a final check, the Company witness employed a capital asset pricing model. Judgment as well as three separate methods was employed because no single method is accurate enough to be relied on, in the opinion of the Company witness.

Instead of using the stock of GTE as a proxy the Company witness studied 103 companies contained in the Standard and Poor's telecommunications data base whose stocks are actively traded, although none of those companies are exclusively engaged in local exchange operations. Company witness Hanley chose from that data base the ones that are reported in both Value Line Investment Survey and Standard and Poor's Stock Guide with common equity ratios above 50 percent. Hanley used an analysis of gas distribution companies as a check because the natural gas industry, like the telephone industry, is perceived to be undergoing a transformation from monopoly to competition. Mr. Hanley used a combination of all of his methods to arrive at a recommended return on common equity of 13.70 percent.

The Staff and the Company each offer a number of criticisms of the methods employed by the other. The Company's initial criticism is in the use of constant growth DCF model by the Staff with the contention that its use is based on a number of unrealistic assumptions. It is the Company's claim that the constant growth DCF calculation understates the investor's required rate of return on common equity.

The Staff's brief points out that the criticism of the constant growth DCF method lodged in this case is much similar to that raised in the recent Southwestern Bell Telephone complaint case. As pointed out in the order in the Bell complaint, this Commission in recent years has almost exclusively used the constant growth DCF method for determining returns on equity. We were of the opinion then, and we are of the opinion now, that the returns developed by the DCF method have been reasonable and have maintained the financial integrity of the utilities. Now, as in the Bell case, we have heard no evidence that the constant growth DCF method suffers any more infirmities than any other of the various methods recommended. We are of the opinion that the Staff's DCF calculation should be used for establishing the Company's return on equity in this matter, with certain modifications.

The Company is critical of the Staff's use of only a three-month period for the calculation of its dividend yield component. In the Commission's opinion the Company's criticism is correct. That period of time is too short to be representive of an average yield over a period of time in the future when the resulting rates in this proceeding may be in effect. The Company suggests that the use of an unadjusted 12-month average dividend yield of 5.63 percent would be more appropriate than the average calculted by the Staff for only the last three months of that period. In the Commission's opinion it is more appropriate to use the longer period of time for the yield portion of the DCF calculation.

The Company is also critical of the Staff's decision to give equal weight to each of the 12 analysts' projections for dividends per share contained in the IBES report and the projection made by Value Line. The Company also criticizes the use of the IBES report because it has a relatively high cost and is not available to many individuals. The Staff points out the evidence establishes that the IBES report is subscribed to by a significant number of investment bankers and brokerage houses who share this information with their investor clientele. The Commission is of the opinion that it is not improper to give full weighting to all of the analysts' projections employed.

The Company is critical of the Staff's determination of a residual cost of equity for telephone exchange operations as being inappropriate. Company alleges that it is an error to attribute a higher rate of return to the higher risk companies claiming that the "portfolio effect" makes GTE less risky than it would be if it only engaged in regulated telephone operations. "Portfolio effect" was described as the reduction in business risks through diversification of a company beyond its core of business. It is the Company's position that, while on an individual basis the subsidiaries in a holding company may exhibit higher risks, in combination they actually act to reduce the overall risk at the parent company level. GTE has not made any quantification of the "portfolio effect". The Commission is of the opinion that its actual effect on the Company's return on equity is not sufficiently known to be the basis of a rejection of the residual calculation.

Finally, the Company is critical of the use of the double leverage concept. Double leverage has been employed repeatedly by the Commission in prior cases. There has been no evidence offered in this case that would alter our belief in its propriety. The purpose of double leverage is to prevent a parent from earning an excessive rate of return on the investment in a subsidiary. The double leverage adjustment reduces the return on common equity of the subsidiary to recognize the fact that some of the equity may have been purchased by the parent's lower cost debt.

The simple fact remains that stockholders gain an advantage from the borrowing of capital at a lower rate than the return they receive on their equity. For ratemaking purposes, it is proper to impute the cost of borrowed money to that portion of the equity structure which may have been purchased with borrowed money.

By making the adjustment to the dividend yield previously described, by the application of double leverage, and including the residual calculation of the cost of equity of the regulated subsidiaries, the Staff's proposed range of returns on equity becomes 12.23 percent to 13.36 percent with a mid-point of 12.80 percent. For the purposes of this case, the rate of return should be adjusted to 13 percent which is in the Staff's range after applying the adjustments which we have determined to be proper.

Applying that figure to the agreed on capital structure, Company's proper overall weighted cost of capital is 10.95 percent.

XI. REVENUE REQUIREMENT

We have previously found the Company's revenues to be $42,427,000 and the Company's operating expenses $33,959,000. Applying the proper factors for income tax and applying the 10.95 percent overall cost of capital to the Company's net original cost rate base in the amount of $75,516,000, Company's net operating income requirement is $8,186,000, or $849,000 more than the net income available.

XII. RATE DESIGN

1. The Alternatives

The Company and Staff propose a different rate design for each of the possible alternatives of revenue reduction, no change in revenues, and a revenue increase. Since we have found a revenue deficiency in this case, it is unnecessary to give extensive consideration to the revenue reduction or the revenue neutral recommendations. The Commission should also note that it could not adopt the Company's revenue neutral proposal since the Company did not support it with any evidence. As pointed out in the Staff's brief, the revenue neutral proposal surfaced for the first time at the prehearing conference, which is not of record, and there is no competent or substantial evidence offered by the Company in this record on which to base an adoption of that position.

The Commission Staff supports a reclassification of the Crane exchange. This reclassification will generate approximately $4,721.

In the event of a revenue increase, the Company and the Staff are in substantial agreement as to the following distribution and amount of increase.

Description of Service:	Amount
Mileage Charges	$168,283
Directory Listings	25,515
Late Payment	313,500
Custom Calling - Calling Waiting	59,953
Custom Calling - Service Package	5,897
Joint User Elimination	420
Suspension of Service	3,040
Exchange Reclassification (Crane)	4,721
Rate Group Consolidation	(839)
A/B Trunk Merger	(219)
Total	$580,271

The Commission finds that the agreement should be accepted and the first $580,271 of increase should be recovered accordingly.

2. Disputed Areas of Increase

The Company proposed to increase service connection charges in the amount $572,676 as one of its first priorities. Company proposes to increase those charges to more nearly capture the cost of rendering the service. The Staff and the Public Counsel oppose this increase.

The Staff is not opposed to the principle of setting the service connection charges to recover costs. However, Staff is of the opinion that the cost studies relied on to support the proposed rates are deficient. It is the Staff's contention that the cost studies do not represent Missouri-specific information, and a Missouri-specific time and motion study should be completed prior to the filing of any tariffs for service connection charges.

Company's rebuttal witness defends the increase by stating that the operation is multistate in nature and there are no longer any pure state-specific functions. It is the Company's contention that the three time and motion studies performed at three different sized offices in other portions of the service area are realistic.

The Public Counsel opposes the increase on the assumption that GTE's proposal would make its residential connection charge the highest service connection charge of any of the primary toll carriers. The Public Counsel witness was assuming that the average customer would require outside plant work resulting in an Outside Plant Charge and an associated Travel Charge. Approximately sixty (60) percent of the Company's new customers would not require that activity and would have service connection charges of approximately $25.45. The substantial remainder would incur service connection charges of $57.40. A Company witness attempted to minimize any fear concerning some customers inability to afford service connection bills because Missouri has adopted the FCC Link-Up America Program which absorbs up to 50 percent of the nonrecurring service connection charges up to $30.

Under the Company's tariff an applicant for that program must be currently receiving MEDICAID/Medical Assistance Payments from the State of Missouri. In the Commission's opinion that condition leaves a substantial body of potential ratepayers who may be in modest circumstances, but not qualifying for assistance from Link-Up America. We are of the opinion that a service connection charge of $57.40 may represent a potential barrier to acquisition of telephone service by that substantial group.

In the Commission's opinion it is proper to move service connection charges for all new customers to the level of $25.45, including outside plant work. This level of charges will generate $242,101 in additional revenues for the Company.

This new service connection charge of $25.45 is approximately two-thirds of the service connection charges approved in the tariffs of Southwestern Bell Telephone Company and United Telephone Company ($36.50 and $36.45, respectively). The Company's proposal, to that extent, is reasonable and should be adopted.

3. Extented Area Service (EAS) Additive

As one of its proposed priority increases the Company seeks permission to increase the EAS additive to customers' bills by a total amount of $451,139. This increase is opposed by the Commission Staff and Public Counsel.

It is the Company's contention that the EAS additives presently recover only 9.4 percent of the cost of rendering EAS. Company's proposal is to double the EAS additive thereby increasing its recovery, according to the Company, of 18.8 percent of the expenses. It is the opinion of the Company witness that the existing underrecovery of cost results in the 15 exchanges, having no EAS, subsidizing those exchanges where the service is available.

In the Commission's opinion the Company's representation that the average increase in the additive is 53 cents per line is somewhat deceptive and should be rejected. As pointed out by a Public Counsel witness, the average 53 cents is somewhat meaningless because of the wide range in EAS additives. As pointed out in that testimony Whitesville residential customers would have a \$5.70 increase and the business customers would have a \$10.55 increase. In the Rosendale exchange those increases would be \$4.25 and \$7.90 respectively.

In the Commission's opinion the Staff's observations concerning Company's basis for this proposed adjustment demonstrates its inadequacy to be the foundation for such a large increase to certain of the Company's customers. GTE compared their current EAS revenues with their estimated EAS costs. Cost estimates were based upon a fully distributed cost study criticized as being inappropriate by the Staff because that procedure arbitrarily allocates common costs to specific service categories. We are of the opinion that it would have been more proper to conduct a current specific study of Missouri EAS additive costs to determine a more precise level of increase. Because of those perceived deficiencies we are of the opinion that the proposal of the Company should be rejected.

4. Proposed Reductions

A. Nontraffic Sensitive Cost (NTS) Shift

The Company proposes to shift NTS costs to local exchange customers over a five-year period. AT&T supports the proposed Company shift. MCI supports the proposed reduction in interstate Common Carrier Line Charge (CCLC), but takes no position on how the Company's rates should be increased to recover the reduction.

The Company alleges the NTS cost shift is necessary to recognize the changes needed for it to be an effective competitor in the interLATA and intraLATA markets. In order to meet that competition, the Company needs to price its services closer to cost. One of the specific reasons for the proposed shift is the contention that the Company is subject to substantial excess revenue loss from customers bypassing the network. The Staff's evidence indicates that bypass is not a serious threat since the Company can only list six incidents going back to January, 1986. In addition, a data request submitted by the Staff resulted in the Company furnishing a category classification of states as to the vulnerability to bypass. Of the three categories established, Missouri was placed in the least vulnerable category.

The Company also desires to make the NTS cost shift because it contends that it is subject to similar toll revenue losses in the intraLATA toll market. Staff's testimony establishes that the Company has a number of exchanges in Missouri which do not generate toll revenues sufficient to justify an interexchange carrier's entry into that market. MCI is available in the Columbia exchange only and U.S. Sprint provides service in six additional exchanges. It is a relatively small percentage of experience out of a total number of exchanges of 46. AT&T, of course, serves in all of the 46 exchanges. In the Commission's opinion there is no persuasive testimony that the threats referred to by the Company are sufficient justification to make the substantial NTS cost shifts and the Company's proposal should be rejected.

An additional reason for the rejection is the failure of the Company to incorporate within its books and records a credit for the NTS shift authorized by the Commission when the intraLATA toll pool was ended. The only NTS cost shift approved by the Commission was a 20 percent shift out of the intraLATA toll services for primary toll carriers upon termination of the intraLATA toll pool occurring on July 1, 1988 in the Commission's Report and Order issued in Case No. TO-88-222 et al. The shift was from intraLATA toll to other vertical services such as touch tone and private line rates and was not a shift to any basic local exchange access line rates as proposed herein. GTE is the first local exchange company in Missouri to propose NTS shifts to local exchange access line rates. GTE has apparently overstated the total NTS cost shift by at least the amount of the shift that occurred when the intraLATA toll pool was ended. Until GTE decides to book NTS cost shifts which the Commission has already authorized, additional NTS cost shifts would obviously be pointless. If the Company refuses or fails to book the appropriate credit, any NTS cost shift authorized will nonetheless result in one hundred percent (100%) of NTS costs still waiting to be "shifted."

B. Billing And Service Charges

As a part of the Company's overall proposal, it intends to reduce charges for services rendered to AT&T for billing and collection services. The Staff is generally opposed to the reduction in charges for any of the subject services when coupled with a request for a general increase in rates.

The billing and collection charges the Company proposes to decrease are in the amount of $320,181 for interLATA traffic and $39,936 for intraLATA traffic.

Since January 1, 1987, the Company has had a contract with AT&T for billing and collection services for interstate traffic. In the instant case, the Company is seeking to reduce the charges rendered to match the interstate charges provided for in the contract. The Company proposes the adjustment on the grounds that since the service is the same, the charges should be the same. In addition, the Company points out that AT&T has alternatives to the services offered by the Company and that prices for the services should reflect market pressures.

In the Commission's opinion, there is insufficient evidence in this record on which to base the proposed reduction. The Company's evidence did not address the existence of a contract with AT&T and that aspect was not raised until the filing of the Company's brief.

C. Toll Rates

The Company proposes to reduce the various toll rates by an average of five (5) percent resulting in a total reduction of $343,519. The reduction consists of (1) Message Toll Service (MTS) of $279,230, (2) WATS of $3,238, (3) 800 Service of $28,581, and (4) Market Area Calling Plan (MARC) of $32,470. The Commission Staff objects to a reduction in toll rates unless there is an overall reduction in the Company's revenues. The Staff opposes any reduction in toll rates which would be coupled with a general increase which shifts the revenue requirement to local exchange service.

The thrust of the Company's request is to permit it to face competition in the intraLATA toll market from AT&T, MCI, and US Sprint. Company's evidence establishes that those toll carriers offer substantial discounts based on the customers' combined volume of use of interstate, interLATA and intraLATA service. Although the Company has 90 percent of the intraLATA traffic in its service area, there is no guarantee that condition will prevail indefinitely. The Company's proposal appears to be an attempt to recognize the realities of emerging competition and it should be allowed to charge market based prices for competitive toll rates.

The Staff has presented what the Commission considers sufficient justification for rejection of the toll rate proposal concerning MARC. This plan offers discounted intraLATA toll rates based on volume. Although the Staff is not opposed to such plans as a generalization MARC was only supported by an Illinois study and the Company made no attempt to establish its expected market penetration in the State of Missouri. As suggested by a Staff witness, the Commission is of the opinion that the quantification of the costs and benefits of implementation of the plan is inaccurate and should be rejected. The Commission will authorize a reduction of toll rates, other than MARC, in the amount of $311,049 subject to an offset discussed in Section XII 5.

D. Access Charges

Company proposes to shift approximately $4,157,000 of access charges from interexchange carriers to local exchange rates. The Company proposes that its switched access rates be set at parity with the most recent corresponding interstate rates. The Company also proposes to reduce its intrastate interLATA carrier common line charges (CCLC) to bring parity between interLATA and intraLATA charges for both originating and terminating traffic. The Company proposes to bring the charges into parity since the services perform virtually the same function regardless of the nature of the traffic. The Company proposes to bring the CCLC to parity over a period of four years in order to lessen the burden on the local exchange customer.

The CCLC is based on the originating and terminating minutes of use. At the time of the hearing the originating CCLC is $.0403 for interLATA traffic and $.0204 for intraLATA traffic. The teriminating CCLC was $.0692 for interLATA traffic and $.0350 for intraLATA traffic. MCI and AT&T support the Company's proposals while Staff and Public Counsel oppose it.

In opposing the Company's proposal the Staff witnesses indicate that a difference in charge is not discriminatory since there are differences existing between interLATA, intraLATA and interstate service which justify different rates. The Staff witnesses contend that the involved rates should be set on market conditions only and should be allowed to generate the maximum amount of contribution.

In addition to supporting the Company's position, AT&T proposes a CCLC revenue cap which would allow toll providers and their customers to be given the benefit of their traffic growth over nontraffic sensitive facilities. In the Commission's opinion the Company's criticism of the proposal has merit, and the proposal should be rejected since there is no guarantee of the assumption that the Company's cost will remain constant over the long run. The capping plan also appears to fail to take into consideration other changes such as increases in taxes which are beyond the Company's control.

In the Commission's opinion it is not reasonable to substantially increase local exchange rates by the shift of the involved $2,740,000.

The net result of the proposed access charge reduction would be to increase rates for local exchange service by about $2.50 per month to offset the corresponding reduction in access charges to interexchange carriers. The average GTE customer would have to make an extraordinary amount of long-distance telephone calls to make the shift revenue-neutral for that individual. Since AT&T uses statewide averaging for its toll rates, the result would be a substantial increase in the local service rates of GTE customers in exchange for a very small reduction in toll rates for the average AT&T customer statewide. Since the access charges paid by AT&T to GTE represent only a small fraction of AT&T's access charges, the reduction in toll rates that would be passed on to GTE's customers would be almost unnoticeable. As such, GTE's customers would be subsidizing the AT&T long-distance customers statewide, but to such an inperceptible amount that it does not justify a substantial increase to the GTE customers. As such, the highly touted toll rate reduction is somewhat illusory.

Another support for the proposal offered by the Company is the presence of the threat of bypass. For reasons recited elsewhere in this Report and Order, the Commission is of the opinion that the threat of bypass is also somewhat illusory and the Company's own studies and records do not justify the contention that it is a serious threat. All in all, the proposed shift in access charges results in too high a price for the GTE customers to pay to achieve a minimum benefit for long-distance customers.

Company's proposal to "mirror" all switched elements of its access charges, as approved by the FCC, would result in a shift of approximately $1,417,000 to local exchange service. The Company is not picking any level of rates. In its original filing the Company proposed to use the February 8, 1989 switched access rates. During the course of this case the FCC rates were changed and the Company filed supplemental direct testimony proposing to reflect May 11, 1989 rates. Company proposes that its cost support for future changes would be its FCC filing and future changes in the switched access rates would be made automatically upon approval of those rates by the FCC on an interstate basis.

The Commission Staff opposes the Company's switched access rate proposal for a number of reasons. The Staff points out that the determination of a revenue requirement at the FCC is a completely separate calculation from the revenue requirement determination on a Missouri state basis. The Staff is critical of the proposal as prohibiting this Commission from engaging in its obligation to establish specific rate levels rather than rubber-stamping parity with the interstate rates because the way the FCC determines rate design may or may not be the same approach as used here.

A second criticism of the Staff is that the Company's proposal to "mirror" the interstate rates appears to be difficult if not impossible. The

Company originally proposed the use of rates that had been filed December 30, 1988. Since the rates are changed so frequently the Company had to file supplemental testimony to stay current with the level of rates it was asking for.

The cost studies filed with the FCC in support of the access rates are described by the Commission Staff as a fully distributed cost study approach. As pointed out in the Staff testimony, there have been parties before the Commission who have suggested that fully distributed costing is a proper standard for setting prices. However, the Commission has never adopted that standard.

The infirmities are too great to accept the Company's proposal to achieve parity in access charges at the present time.

5. Rates Authorized

We have previously found the overall revenue deficiency in this case to be $849,000. When combined with the toll reduction in the amount of $311,049, the total amount for distribution is approximately $1,160,049. Since we have previously determined that there should be a recovery of $580,271 by the items contained in the Company-Staff recommendation and $242,101 should be recovered by service connection charges, the amount remaining to be recovered is $337,676.

The various parties have presented the Commission with an almost infinite number of combinations of rates that should be or should not be increased or decreased. In considering all of these potential results, the Commission is of the opinion that the remaining amount of revenues to be distributed should be placed on basic exchange service. The amount to be recovered is approximately 2.5 percent of the $13,494,114 which the Company proposed to add to basic exchange rates over a five-year period.

The Company's rates have not been increased since August 6, 1983 in Case No. TR-83-164. To the contrary, the rates were decreased by $2,100,000 in Case No. TC-87-57 effective May 15, 1987, which included a fifteen percent (15%) decrease in basic local rates. The Company's rates are among the lowest of Missouri companies of comparable size or larger. Many of the Company's rates for residential one-party service are lower than other of the Company's customers pay for an EAS additive. For these reasons, we are of the opinion that it is reasonable to assess a portion of the revenue shortfall and revenue shifts to local exchange service.

The Company's evidence includes information concerning an FCC analysis released in August, 1989, which establishes the national average rate for a residential one-party service to be $17.59. Although we do not, and cannot, advocate setting rates by formula, rule of thumb, or rate comparison, we deem it appropriate to use these comparisons to aid in our judgment of whether the resultant rates are fair and reasonable.

The increase in basic local rates herein authorized should be applied on an equal percentage basis to all rate classifications and groups, after the rate group consolidation and the merger of rates for A and B trunks.

XIII. INCENTIVE REGULATION PLAN

During the past year, the Commission has directly acknowledged the need for "incentive regulation" for local exchange telephone companies. A growing number of services offered by these companies are subject to competition (eg., toll, numerous business services like digital data and centrex, and various custom calling features). To the extent that the companies do well in marketing these services, the revenues therefrom may contribute toward keeping basic local rates from rising. However, under traditional regulatory models, if a company performs well in these competitive markets and thereby increases its earned return, it then must lower its rates to pass this enhanced return back to its ratepayers. This discourages efforts to maximize performance in competitive markets.

"Incentive regulation" is a mechanism for providing LECs with real, financial incentives to perform well in competitive markets. The object of incentive regulation is to encourage the LEC to reduce costs, improve productivity, improve service and market services more effectively in order to enhance profit, because both shareholders and ratepayers will benefit thereby.

In September, 1989, this Commission established an incentive regulation plan for Southwestern Bell Telephone Company as part of its settlement of the appeals arising out of In Re: Southwestern Bell, TC-89-14 et al., 29 Mo. P.S.C. (N.S.) 605 (1989). Under the SWB incentive plan, the Company retains the full benefit of any return on equity (ROE) it earns up to 14.1 percent. If Bell's ROE exceeds 14.1 percent, it shares 60 percent of the excess return with its ratepayers. If its earned ROE exceeds 14.5 percent, the excess return is shared 50-50 between shareholders and ratepayers. A financial monitoring system was established, as was a refund mechanism.

In the instant case, the Company, Staff and Public Counsel all propose different versions of an incentive regulation plan which would be a substitute for traditional methods of regulation including the filing of conventional rate cases such as herein involved. MCI and AT&T generally support the concept of incentive regulation, but advocate the inclusion of certain safeguards such as inclusion of all customers in the group that will share in the benefits of the plan.

Although the three plans contain a multitude of differences, the Company primarily objects to the Staff and Public Counsel's proposed plan from the nature and concept of the revenue sharing grid. Company contends that the spreads contained in the Public Counsel's plan were so great that the Company would have no realistic opportunity to increase its share of earnings to the point where the Company and the customers would share equally in the benefits. The Company is critical of the Staff proposal because of the Company's perception that the number of tiers in the sharing grid would make the plan administratively impractical.

The Company in its brief takes the position that any plan adopted by the Commission which differs from the one proposed by the Company would have to be expressly concurred in by the Company before becoming legally binding to restrict the Company's statutory rights, particularly in the area of filing tariffs and prosecuting a conventional rate case. In its reply brief, the Company reiterates this position that the Commission cannot validly adopt an incentive regulation plan without the concurrence of the Company. The Commission strongly rejects that position.

However, the Company witness testifying in support of incentive regulation indicates that there has been an insufficient presentation to be the foundation of a concrete plan. The Company witness listed several open questions which must be determined by further discussions. Among those open questions are: (1) scope and structure of monitoring; (2) whether or not to recognize exogenous factors; (3) the process by which revenue credits or rate increases would be treated in the earnings monitoring; and (4) the timing of the filing of reports. In addition to the specifically mentioned undetermined items, the Company witness concluded with "and so on." It is difficult to ascertain how many items may be contained in "and so on." Also, when asked whether the Company could change its return on equity, capital structure and revenue sharing grid during the pendency of the plan, the witness indicated he did not know. The Company witness is also unsure as to what separation factors to use. For all of these reasons, the Commission is of the opinion that there are too many missing links to permit the fashioning of a plan, based solely on the record herein.

However, the Commission is committed to seeing an incentive plan pursued and developed for GTE. Therefore, a separate docket should be instituted for the purpose of inviting the interested parties to supply all of the necessary components of a plan. Properly fashioned, an incentive regulation plan may be beneficial to Company and ratepayer alike. One potential benefit is the elimination of time and expense of the conventional rate case such as the one in which we are herein involved. Another advantage is the potential benefit to ratepayers resulting from economic incentives on the part of the Company to improve service and effect savings. While these desirable goals unfortunately cannot be further advanced on the basis of the instant record, the Commission strongly encourages the parties to actively participate in the incentive proceeding and to cooperatively and diligently seek to develop a workable incentive model for GTE North.

XIV. CONCLUSIONS OF LAW

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

GTE is a public utility subject to the jurisdiction of this Commission pursuant to Chapters 386 and 392, RSMo (Supp. 1989). GTE is a telecommunications company engaged in the provision of local exchange service in several exchanges throughout the State of Missouri.

The complaint filed by the Commission Staff in this matter was filed pursuant to Section 392.420.

The Commission, in determining whether there should be a reduction, or an increase, in GTE's revenue requirement, may consider all facts which in its judgment have any bearing upon a proper determination of setting just and reasonable rates. In considering the evidence in these consolidated proceedings, the Commission has determined that GTE's revenue requirement should be increased by $849,000 and rate shifts should be effected in the approximate amount of $3,051,049.

Because we are obligated to consider all relevant factors in setting current reasonable rates, proposals in this case have been rejected which would increase rates using automatic single adjustment factors such as a consumer price index.

For ratemaking purposes the Commission may accept a Stipulation and Agreement in disposition of any and all issues presented. Partial stipulations between the parties have been accepted by the Commission and have been embodied in the results contained in this Report and Order.

Orders of the Commission must be based upon competent and substantial evidence. Several proposals in the instant case have been rejected because not supported by evidence either sufficiently competent or substantial to be the basis of an adoption.

It is, therefore,

ORDERED: 1. That the tariffs under suspension in Case No. TR-89-238 pertaining to proposed billing and collection charges are hereby disallowed.

ORDERED: 2. That the tariffs under suspension in Case No. TR-89-182 covering the proposed increase in rates and charges for telephone service are hereby disallowed and the Company is authorized to file for Commission approval tariffs embodying the revenue requirement and rate design herein described.

ORDERED: 3. That the complaint of the Staff of the Missouri Public Service Commission pending in Case No. TC-90-75 is hereby dismissed.

ORDERED: 4. Effective January 1, 1990, GTE shall accrue and record depreciation expense pursuant to the depreciation rates herein adopted and attached hereto as Appendix 1 which is hereby received into evidence as Exhibit No. 165.

ORDERED: 5. That Case No. TO-90-180 is hereby opened, and shall be styled, "In the matter of the consideration of an Incentive Regulation Plan for GTE North Incorporated," for the purposes previously recited herein.

ORDERED: 6. That this Report and Order shall become effective on the 20th day of February, 1990.

BY THE COMMISSION

Daniel J. Redel

Daniel J. Redel
Acting Secretary

(S E A L)

Steinmeier, Chm., Mueller, and
Rauch, CC., Concur and certify
complaince with the provisions
of Section 536.080, RSMo 1986.
McClure and Letsch, CC.,
Not Participating.

Dated at Jefferson City, Missouri,
this 9th day of February, 1990.

APPENDIX B, PAGE 2 (REVISED)
PLANT BALANCES AT 12/31/88
TR-89-182

Acct	Description	Reserve %	R/L yrs	FNS %	RATE %	P/L yrs	Curve
	A	B	C	D	E	F	G
2112	Motor Vehicles	32.0	4.0	13	13.8	8	L3
2115	Garage Work Eq.	21.9	11.9	0	6.6	20	R1
2116	Other Work Eq.	19.9	10.0	10	7.0	18	L0
2121	Buildings	30.9	29.0	5	2.2	43	R2
2122	Furniture	33.7	8.4	10	6.7	15	L1
2123	Co. Commun. Eq.	59.7	5.0	-4	8.9	7	L1
2124	Gen. Purpose Computers	8.2	4.7	10	17.4	7	R2
2212	Digital Electro Sw.	25.3	12.8	10	5.1	20	R1.5
2215	Electro Mechanical						
	Switching Eq.	14.4	5.4	1	15.7	-----N/A----	
	Recording Eq.	56.0	6.2	0	7.1	-----N/A----	
2231	Radio Eq.	22.6	5.4	-2	14.7	11	L2
2232	Circuit Eq.	2.4	6.7	20	11.6	12	L0
2351	Public Tele. Term Eq.	79.2	6.6	10	1.6	9	L1
2362	Oth. Term Eq. Ntwk Chnl	78.2	4.8	1	4.3	7	L1
2411	Poles	44.8	11.2	-25	7.2	20	L0
2421	Aerial Cable						
	Metallic	25.6	10.5	-6	7.7	18	L1
	Non-Metallic	13.7	21.0	-5	4.3	30	R2
2422	Underground Cable						
	Metallic	17.2	18.7	0	4.4	30	R1
	Non-Metallic	8.8	24.0	-2	3.9	35	R2
2423	Buried Cable						
	Metallic	27.3	13.0	0	5.6	20	L3
	Non-Metallic	14.2	21.0	-2	4.2	30	R2
2426	Intrabldg. Netwk. Cable	29.3	15.5	-7	5.0	20	L1
2431	Aerial Wire	125.0	4.3	-44	4.4	9	L1
2441	Conduit Systems	24.4	43.0	0	1.8	55	R3