BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

Contel System of Missouri, Inc. Response to the Order Initiating Investigation Issued November 3, 1986	))))	Case No. AO-87-48 Effects of 1986 Federal Tax Reform

In response to the above referenced Order Initiating Investigation issued November 3, 1986, Contel System of Missouri, Inc. (the Company) submits the following information per the guidelines provided in this Order.

The Company has made preliminary estimates of the effects that the Tax Reform Act of 1986 will have on its current income tax payment, deferred tax accruals and revenue requirements. The Company made these estimates based upon its December 31, 1985 financial data, consistent with the Company's last rate case (Case No. TR-81-59). The attached Schedules 1, 2 and 3 reflect the respective revenue requirement, rate base and income statement of the Company at 12/31/85 prior to the adjustments needed to reflect the Tax Reform Act. Schedule 4 details the change in the current tax payment, income tax provision (including deferred taxes) and revenue requirement. As Schedule 4 indicates, the current State and Federal tax payment (columns b and c) on a jurisdictional basis for 1985 is approximately $383,500 using the current 46% tax rate and deductions allowable under the current tax law. Keeping the tax rate at 46% but taking into consideration the remaining provisions of the new tax law (elimination of investment tax credit, bad debts accrual and the disallowance of the current tax deduction for interest, taxes and pensions capitalized), this

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current payment, shown in columns d and e, rises to approximately $1,699,000. This reflects an increase in current taxes payable of approximately $1,316,000. The related deferred tax expenses decreased by approximately $1,271,000. The major reason for the swing between current and deferred taxes is due to the elimination of the investment tax credit. As this comparison indicates, total Federal and State income tax provisions under the new tax law would increase approximately $45,000 if the tax rate remained constant at 46%.

Schedule 4, columns f and g, provides the tax provision change directly applicable to the rate change from 46% to 40%. The excess deferred taxes applicable to accelerated depreciation that result from this rate change are addressed in this comparison also. The new tax law requires this excess be normalized and restored to income over a period of years using the average rate assumption method. Using this methodology and the blended effective tax rate of 40%, the Company estimates on line 29 that approximately $88,000 of excess jurisdictional deferred taxes would be credited to income (see Schedule 5). The amount credited to income in future years will fluctuate significantly depending on the actual reversal of the timing differences. The total decrease in the tax provision including the excess tax income credit is approximately $235,000. The resulting revenue impact of the new tax laws and the blended 40% federal tax rate is approximately $396,000.

Schedule 4, columns h and i, provides the further tax provision change in the years subsequent to 1987 when the full impact of the rate change from 46% to 34% will be effective rather than the blended 1987 effect shown in columns f and g. The tax decrease would be approximately $513,000 in 1988. The resulting revenue impact would be approximately $791,000. The total income tax provision will decrease initially (as detailed on Schedule 4) and therefore initially there will be a benefit to both the Company's customers and its shareholders. In the long term, however, it appears that the changes required by this law will ultimately increase the tax liability of the Company and work to the detriment of both the customers and the shareholders. The major consideration being the elimination of investment credit and its subsequent amortization. As a result of the elimination of investment tax credit effective January 1, 1986, the Company estimates that it will forego the following amounts of investment tax credit during the years 1986 through 1988:

Year	Estimated Lost Investment Tax Credit
1986	$348,000
1987	643,000
1988	499,000

Loss of this credit will result in foregone amortization and have the effect of increasing future periods income tax expense in the following amounts:

Investment Credit Year	Estimated Reduced Amortization 1986	1987	1988
1986	$10,200	$20,400	$20,400
1987	-	18,850	37,700
1988	-	-	14,600
	$10,200	$39,250	$72,700
Jurisdictional Factor	.7560	.7560	.7560
Increased Jursidictional Tax Expense	$ 7,700	$29,700	$55,000

Projected amortization computed using the 1985 composite rate of 5.8550%.

Since the full effects of the provisions of the new law will not be felt for several years, the Company feels that the Commission should concentrate its efforts on those changes which will become effective during the calendar year 1987. The Commission should also consider that changes from this Act are not absolute since members of Congress have already begun discussing a tax increase during the next session of Congress to follow this tax reform. Any procedures which this Commission adopts as a result of this proceeding should envision applicability to further changes (either positive or negative) which may occur during the next several years.

The Company feels that the Commission should take further time to study the effects of this recently enacted legislation. The blended 40% tax rate which will be effective in 1987 is derived through a rate change from 46% to 34% effective July 1, 1987. Therefore, the Company feels that any action taken by this Commission need not be effective prior to July 1, 1987. It is the Company's position that this Commission should consider potential actions which it could take, while taking advantage of the time between now and July, 1987 for further study.

The Company is greatly concerned with the effect that several key issues, whose impact cannot be measured at this early date, will have on the Company. Preliminary review indicates that the Alternative Minimum Tax (AMT) will not impact the Company in 1987 or 1988. However, in future years the potential increase in tax expense related to AMT may affect the Company's operations. The reduction in internally generated funds may place the Company in a position which requires further long-term debt commitments. Any resulting issue of additional long-term debt will have the effect of lowering its equity ratio which could potentially require an increased return on equity and ultimately affect the Company's required rate of return. As indicated on Schedule 6, the impact of tax reform is not specifically attributable to the local jurisdiction. Of the estimated $791,000 revenue requirement impact from the Tax Reform Act, $397,000 is attributable to the local jurisdiction while $394,000 is attributable to the intrastate interLATA and intraLATA jurisdictions. Current or proposed impacts of the Tax Reform Act on the toll pools or access charges must be determined prior to a determination of the ultimate effect on local operations.

The Company believes that the Commission should explore through an interim order in this docket the parameters within which it would consider individual company proposals to effectuate any changes required by the new law. These parameters might include such items as test period to be used or types of adjustments which might be considered. In doing so, it should establish a deadline for input in those parameters which would be considered by the Commission and subsequently for individual companies to file plans with the Commission which will allow the Commission time to consider these proposals prior to a July 1, 1987 effective date. Since individual company situations vary, even within the same industry, such a proposal would allow companies to propose plans which deal specifically with the needs of their customer and their shareholders.

The Company is considering several alternatives to deal with these law changes including, but not limited to:

1. Potential capital-recovery issues.
2. Potential shift of NTS cost to end user.
3. Potential for implementing optional local measured service on a

statewide basis.

4. Potential reductions in local service rates.

The Company believes that items such as those enumerated above could be considered as part of this proceeding dealing with the Tax Reform Act of 1986.

The Company wishes to emphasize that the information provided herein is based on 1985 data, estimates in many cases, and our preliminary interpretation of the Tax Reform Act. While the Commission feels it is reasonable to assume that utilities in Missouri have preliminary estimates of the impact of tax reform, the information included herein should be considered in that light and regarded only as estimates. As additional information concerning the tax law and 1986 information becomes available, these preliminary estimates must be updated.

CONTEL SYSTEM OF MISSOURI, INC.

By: WMEdwards III

William M. Edwards, III

Vice President

Schedule 1

CONTEL SYSTEM OF MISSOURI, INC.

Revenue Requirement

Line No.	Description (a)	Amount (b)
1.	Jurisdictional Rate Base	$24,381,084
2.	Rate of Return	11.32%
3.	Net Operating Income Requirement	$ 2,759,939

CONTEL SYSTEM OF MISSOURI, INC.

Rate Base

Line No.	Description (a)	12/31/85 Jurisdictional Amounts (b)
1.	Total Plant in Service	$ 44,583,730
2.	Depreciation Reserve	(13,666,551)
3.	Net Plant in Service	$ 30,917,179
	Add	
4.	Material & Supply	136,710
5.	Prepayments	21,317
	Less	
6.	Customer Deposits	(191,905)
7.	Customer Advances for Construction	-
8.	Deferred Income Taxes	(6,494,373)
9.	Pre-1971 ITC	(7,844)
10.	Total Rate Base	$ 24,381,084

Schedule 3

CONTEL SYSTEM OF MISSOURI, INC.

Income Statement

Line No.	Description	12/31/85 Jurisdictional Amounts
	Operating Revenues	
1.	Local Service Revenues	$ 7,505,245
2.	Toll Service Revenues	7,292,687
3.	Miscellaneous Revenues	791,213
4.	Uncollectible Revenues	(3,580)
5.	Total Operating Revenues	$15,585,565
	Operating Expenses	
6.	Maintenance Expense	$ 2,803,853
7.	Traffic Expense	345,746
8.	Commercial Expense	1,213,579
9.	General Office Expense	1,631,824
10.	Other Operating Expense	658,602
11.	Depreciation & Amortization Expense	2,319,588
12.	Taxes Other than Income Taxes	812,873
13.	Total Cperating Expenses	$ 9,786,065
14.	Net Income Before Taxes	5,799,500
15.	Current Income Taxes	$ 383,516
	Deferred Income Tax	
16.	Deferred ITC Provision	$ 1,270,803
17.	Amortization of ITC	(188,017)
18.	Deferred Income Tax Expense	652,352
19.	Deferred Income Tax Amortization	(7,031)
20.	Total Income Taxes	$ 2,111,623 *
21.	Net Operating Income	$ 3,687,877

* Income taxes calculated prior to Tax Reform Act of 1986.

CONTEL SYSTEM OF MISSOURI

Schedule 4

Revenue Requirement Impact of Federal Tax
Changes to 1985 Jurisdictional Operations

Line No.	Description	FIT @ 46%		Impact of Tax Changes FIT Remaining @ 46%		Impact of Tax Changes FIT Changing to 40%		Impact of Tax Changes FIT Changing to 34%	
		State	Federal	State	Federal	State	Federal	State	Federal
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
1.	Net Income	$ 3,687,877	$ 3,687,877	$ 3,642,999	$ 3,642,999	$ 3,922,958	$ 3,922,958	$ 4,201,271	$ 4,201,271
2.	Current SIT	$ 159,257	$ 159,257	$ 98,876	$ 98,876	$ 109,526	$ 109,526	$ 120,110	$ 120,110
3.	Current FIT	224,259	224,259	1,600,321	1,600,321	1,387,324	1,387,234	1,175,627	1,175,627
4.	Deferred SIT	37,913	37,913	37,913	37,913	42,034	42,034	46,155	46,155
5.	Deferred FIT	614,439	614,439	614,439	614,439	532,706	532,706	451,385	451,385
6.	Deferred Invest. Tax Credit	1,270,803	1,270,803	-	-	-	-	-	-
7.	Amortization of ITC	(195,048)	(195,048)	(195,048)	(195,048)	(195,048)	(195,048)	(195,048)	(195,048)
8.	Total Taxes	$ 2,111,623	$ 2,111,623	$ 2,156,501	$ 2,156,501	$ 1,876,542	$ 1,876,542	$ 1,598,229	$ 1,598,229
9.	Net Operating Inc. Before Tax	$ 5,799,500	$ 5,799,500	$ 5,799,500	$ 5,799,500	$ 5,799,500	$ 5,799,500	$ 5,799,500	$ 5,799,500
	Adds								
10.	Depr. on Interest Capitalized	$ 45,123	$ 45,123	$ 45,123	$ 45,123	$ 45,123	$ 45,123	$ 45,123	$ 45,123
11.	Depr. on Taxes Capitalized	18,801	18,801	18,801	18,801	18,801	18,801	18,801	18,801
12.	Depr. on Pensions Capitalized	11,281	11,281	11,281	11,281	11,281	11,281	11,281	11,281
13.	Total Adds	$ 75,205	$ 75,205	$ 75,205	$ 75,205	$ 75,205	$ 75,205	$ 75,205	$ 75,205
	Deductions								
14.	Fixed Charges	$ 949,680	$ 949,680	$ 949,680	$ 949,680	$ 949,680	$ 949,680	$ 949,680	$ 949,680
15.	Capitalized Interest	41,889	41,889	-	-	-	-	-	-
16.	Payroll Taxes Capitalized	33,461	33,461	-	-	-	-	-	-
17.	Pensions Capitalized	10,800	10,800	-	-	-	-	-	-
18.	Deferred Charges	10,414	10,414	10,414	10,414	10,414	10,414	10,414	10,414
19.	Sales Tax Capitalized	55,820	55,820	-	-	-	-	-	-
20.	Excess Tax Depreciation	1,300,857	1,300,857	1,300,857	1,300,857	1,300,857	1,300,857	1,300,857	1,300,857
21.	Removal Costs	62,392	62,392	62,392	62,392	62,392	62,392	62,392	62,392
22.	1/4 of 10/86 Uncollectible Res.	-	-	(26,472)	(26,472)	(26,472)	(26,472)	(26,472)	(26,472)
23.	Total Deductions	$ 2,465,313	$ 2,465,313	$ 2,296,871	$ 2,296,871	$ 2,296,871	$ 2,296,871	$ 2,296,871	$ 2,296,871
24.	Taxable Income	$ 3,409,392	$ 3,409,392	$ 3,577,834	$ 3,577,834	$ 3,577,834	$ 3,577,834	$ 3,577,834	$ 3,577,834
25.	Less Curr. Fed. Provision	224,259	-	1,600,321	-	1,387,324	-	1,175,627	-
26.	Less Curr. State Provision	-	159,257	-	98,876	-	109,526	-	120,110
27.	Tax Base	$ 3,185,133	$ 3,250,135	$ 1,977,513	$ 3,478,958	$ 2,190,510	$ 3,468,308	$ 2,402,207	$ 3,457,724
28.	Tax Rate	.05	.46	.05	.46	.05	.40	.05	.34
29.	Tax Provision	$ 159,257	$ 1,495,062	$ 98,876	$ 1,600,321	$ 109,526	$ 1,387,324	$ 120,110	$ 1,175,627
30.	Less Inv. Tax Credit	-	(1,270,803)	-	-	-	-	-	-
31.	Less Excess Def. Tax/Accl. Dep.	-	-	-	-	-	(88,155)	-	(176,310)
32.	Current Tax Provision	$ 159,257	$ 224,259	$ 98,876	$ 1,600,321	$ 109,526	$ 1,299,169	$ 120,110	$ 999,317
33.	Incr. (Decr.) Current Tax Exp.				1,315,681		(202,347)		(201,113)
34.	Incr. (Decr.) Deferred Tax Exp.				(1,270,803)		(77,612)		(77,200)
35.	Total Increase (Decrease) Tax Expense				$ 44,878		$ (279,959)		$ (278,313)
36.	Cumulative Increase (Decrease) to Income				$ (44,878)		$ 235,081		$ 513,394
37.	Revenue Conversion Factor				.537358		.593371		.648736
38.	Cumulative Revenue Impact				$ (83,516)		$ 396,179		$ 791,376

CONTEL SYSTEM OF MISSOURI, INC.

Excess Deferred Tax Adjustment Applicable to Accelerated Depreciation

Line No.	Description (a)	Fed. Rate From 46% to 40% (b)	Fed. Rate From 46% to 34% (c)
1.	Estimated 1987 Book Over Tax Provision	$1,943,450	$1,943,450
2.	Average Rate Assumption Method (46% - 40%)	.06	.12
3.	Total Company Excess Taxes	$ 116,607	$ 233,214
4.	Jurisdictional Factor	75.60%	75.60%
5.	Jurisdictional Excess Tax	$ 88,155	$ 176,310

CONTEL SYSTEM OF MISSOURI, INC.

Estimated Change in 1985 Revenue Requirement Resulting from Tax Change

Line No.	Description (a)	Local Jurisdiction (b)	Intrastate Toll Jurisdiction (c)	Total Intrastate (d)
1.	NOI Before Tax Change	$1,853,404	$1,834,473	$3,687,877
2.	NOI - New Tax Law @ 34%	2,111,385	2,089,886	4,201,271
3.	Increase in NOI	$ 257,981	$ 255,413	$ 513,394
4.	Revenue Conversion Factor	.648736	.648736	.648736
5.	Change in Revenue Requirement	$ 397,667	$ 393,709	$ 791,376

Schedule 6