R&O Binder

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

The Staff of the Missouri Public Service Commission, Complainant, v. Southwestern Bell Telephone Company, a Missouri corporation, Respondent.	)	Case No. TC-89-14
Public Counsel for the State of Missouri, Complainant, v. Southwestern Bell Telephone Company, Respondent.	)	Case No. TC-89-21
In the matter of the investigation of the rate design of Southwestern Bell Telephone Company.	)	Case No. TO-89-29
In the matter of a rate stability proposal for Southwestern Bell Telephone Company.	)	Case No. TO-89-10

REPORT AND ORDER

Hearing Examiners: Cecil I. Wright
C. Gene Fee
Beth O'Donnell

Date Issued: June 20, 1989

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Appearances

Mary Ann Young, General Counsel, Steven Dottheim, Deputy General Counsel, Linda K. Ohlemeyer, Deputy General Counsel, Richard W. French, Deputy General Counsel, Douglas C. Walther, Assistant General Counsel, Charles Brent Stewart, Assistant General Counsel, William K. Haas, Assistant General Counsel, William M. Shansey, Assistant General Counsel, and Penny G. Baker, Assistant General Counsel, Missouri Public Service Commission, Post Office Box 360, Jefferson City, Missouri 65102, for the staff of the Missouri Public Service Commission.

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REPORT AND ORDER

Introduction

On September 28, 1988, the Commission issued an order consolidating Cases No. TC-89-14, TC-89-21, TO-89-29 and TO-89-10, granting interventions in these consolidated cases and establishing a procedural schedule for these consolidated cases. The order consolidating the cases was in response to pleadings concerning consolidation and proposing possible procedural schedules in the individual cases. These proceedings were initiated by complaint filings by Commission Staff and the Office of Public Counsel, TC-89-14 and TC-89-21 respectively, alleging that Southwestern Bell Telephone Company's existing rates are excessive and should be reduced.

In addition to its complaint, Staff requested the Commission establish a separate rate design case, TO-89-29. Prior to the filing of the complaints, SWB had filed its TeleFuture 2000 plan which proposed a network modernization plan, a freeze on local rates through June 30, 1990, local rates priced according to changes in the Consumer Price Index after June 30, 1990, and a continuation of TRA credits through June 30, 1989. SWB's proposal was docketed as Case No. TO-89-10.

The Commission consolidated these four cases because it determined it should address all matters concerning SWB's revenue requirement and rates in one proceeding. The Commission determined that the revenue requirement issues should be heard first and rate design and the TeleFuture 2000 proposal heard separately in later hearings. The hearings were conducted as scheduled.

As part of the discovery process in these proceedings the Commission established a Protective Order. That Protective Order was modified after hearing. Testimony and evidence in these proceedings have been filed and classified under the provisions of the Protective Order as modified.

A Hearing Memorandum, Exhibit 1, was filed by the parties setting out the issues to be addressed in the revenue requirement portion of the proceedings. A

Hearing Memorandum, Exhibit 203, was filed by the parties setting out the issues to be addressed in the rate design/TeleFuture 2000 portion of the proceedings. During the course of the hearings issues were settled or stipulated. Issues will be addressed in this order as set out in the Hearing Memorandum subject to modification based upon agreements or the evidence presented.

Several parties filed joint briefs or had joint counsel, while other parties appeared and filed briefs individually. Below is a list of the parties as they are referred to in this order.

PC	Office of Public Counsel
SWB	Southwestern Bell Telephone Company
KCCP et al.	Kansas City Cable Partners, Midwest Cellular Telephone Company, American Operator Services, Inc.
MICPA	Midwest Independent Coin Payphone Association
CompTel et al.	Competitive Telecommunications Association of Missouri, CyberTel Cellular Telephone Company, Com-Link 21 Inc.
MCI	MCI Telecommunications Corporation
Contel et al.	Contel of Missouri, Inc., Contel System of Missouri, Inc., Webster County Telephone Company,
35 Telcos	Missouri Telephone Company, Eastern Missouri Telephone Company, Mid-Missouri Telephone Company, Citizens Telephone Company, Le-Ru Telephone Company, Steelville Telephone Exchange, Inc., New London Telephone Company, New Florence Telephone Company, Inc., Oregon Farmers Mutual Telephone Company, Mark Twain Rural Telephone Company, Fidelity Telephone Company, Grand River Mutual Telephone Corporation, Green Hills Telephone Corporation, Wheeling Telephone Company, Northeast Missouri Rural Telephone Company, Kingdom Telephone Company, KLM Telephone Company, Ellington Telephone Company, Chariton Valley Telephone Corporation, Alma Telephone Company, Farber Telephone Company, Rock Port Telephone Company, MoKan Dial, Inc., Orchard Farm Telephone Company, Iamo Telephone Company, Bourbeuse Telephone Company, Choctaw Telephone Company, Craw-Kan Telephone

	Cooperative, Inc., Holway Telephone Company, McDonald County Telephone Company, Miller Telephone Company, Peace Valley Telephone Company, Inc., Lathrop Telephone Company, Stoutland, Telephone Company, ALLTEL Missouri, Inc.
DOD	United States Department of Defense and all other Federal Executive Agencies
Retailers	Missouri Retailers Association
Sprint	US Sprint Communications Company
GTE	GTE North Incorporated
AT&T (or, individually, AT&T-Com and AT&T-IS)	AT&T Communications of the Southwest, Inc., AT&T Information Systems Inc.
United	United Telephone Company of Missouri
Oak Grove	City of Oak Grove, Missouri
CWA	Communications Workers of America, AFL-CIO

Findings of Fact

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

Throughout this case there has been tension between PC, Staff and intervenors and SWB concerning access to and the disclosure of information relating to SWB's operations. The Commission was able to resolve this tension in the discovery process through the establishment and later modification of a Protective Order. The Protective Order, as modified, allowed SWB and other parties to designate information in two classifications, Highly Confidential and Proprietary. Each classification had different criteria for who had access to the designated information.

The use of this dual classification procedure has sometimes made the presentation of the evidence in these proceedings an almost unsolvable labyrinth. This is evidenced in the marking of exhibits. At the hearing, exhibits have been marked numerically. If the entire exhibit or a portion thereof is not claimed to be confidential, the exhibit is numbered, for example, as Exhibit 1. If part or all of the exhibit is claimed to be Proprietary, that portion claimed to be Proprietary is marked separately. (Example: Exhibit 1P). If part or all of the exhibit is claimed to be Highly Confidential, that portion claimed to be Highly Confidential is marked separately. (Example: Exhibit 1HC).

The effect of the broad use of the confidential designations on the public record was raised by the Commission during the proceedings. The Commission, with accommodation by the parties, was able to hear most of the evidence in open hearings. Certain portions of the proceedings were conducted as either in camera Proprietary or in camera Highly Confidential.

The Commission informed the parties at the hearing that it would abide by the confidential designations where the information was not necessary for the Commission's findings. The Commission informed the parties, and has again determined, that where necessary to make the findings of fact, the Commission will use information designated Proprietary or Highly Confidential. The use of such information in this Report And Order will indicate that the Commission has determined the information is not confidential and should be made public. The Commission has determined that it is not in the public interest to issue all or a part of this Report And Order under seal.

The Commission has reviewed and considered all of the evidence and positions of the parties presented in this case. Because of the volume of material, the Commission has only addressed that evidence and those positions which it found to be relevant to reaching a decision on each issue. The failure of the Commission to mention evidence or a position indicates that the Commission did not find the evidence or position necessary to the resolution of the issue.

I. Revenue Requirement (Cases No. TC-89-14 and TC-89-21)

A. Test Year/True-up

For the purposes of its audit of the operations of SWB, Staff utilizes a 1987 test year. The 1987 test year was utilized as the most recent 12 months of actual financial data available to Staff during its audit. Staff's audit began in November 1987 and concluded with the filing of the complaint case in August 1988. The test year results became available in February 1988, with certain items not available until April 1988. As a result of its audit Staff made adjustments to the test year data. These adjustments fall into four categories, as discussed by Staff witness Schallenberg. These categories are: normalization adjustments, annualization adjustments, disallowances, and pro forma adjustments. By adjusting the test year data Staff proposes what it considers the appropriate revenue requirement for SWB for setting rates on a going-forward basis.

SWB contends that Staff's test year and adjustments are not representative of SWB's actual 1987 financial picture, nor do they represent an appropriate basis for setting rates beyond the Report And Order in this case. Since the Report And Order will be issued in mid-1989, SWB contends the data used to set rates will be stale. SWB witness Robertson presented three different test year methods for the Commission. SWB argues that the Commission should use 1987 actual data if the Commission wishes to determine if SWB overearned in 1987, while the Commission should use projected data if the Commission wishes to set rates for the future.

In addition, SWB proposed a true-up of Staff's test year with 1988 actual data. The specifics of the true-up proposal were provided at the hearing. Robertson testified all SWB data for 1988 would be available by February 27, 1989. Staff and Public Counsel opposed a true-up in their testimony and specifically objected to the true-up proposed by SWB at the hearing. Their objections rested mainly on the time required to audit the actual data and that no true-up was necessary based upon the 1988 data which had been reviewed.

In setting rates, there is always a question of the appropriate test year to use. The Commission has traditionally utilized an historical test year as a basis for determining just and reasonable rates for a future period. The Commission has broad discretion in the determination of the appropriate methodology for determining a public utility's revenue requirement and it may make adjustments to the test year called for by the particular circumstances in each case. State ex rel. Associated Natural Gas Co. v. P.S.C., 714 S.W.2d, 870, 880 (Mo. App. 1985).

The dispute between the parties over the appropriate test year is really an argument over what adjustments to make to the test year data. Staff and PC have proposed certain adjustments which SWB objects to, while Staff and PC object to certain SWB proposals to include other items and to true up the data with 1988 actuals. The Commission is not constrained by any rigid formula in reaching its decision. It may treat one item of operating expense differently from another and it may include or exclude items from a company's cost of service (COS). State ex rel. Missouri Public Service Company v. Pierce, 604 S.W.2d 623, 625 (Mo. App. 1980); Hotel Continental v. Burton, 234 S.W.2d 75 (Mo. 1960); Utility Consumers Council of Missouri v. P.S.C., 585 S.W.2d 41, 51 (Mo. banc 1979).

The Commission has determined this case is no different from other cases before the Commission. The Commission finds the 1987 test year is a reasonable basis for beginning consideration of SWB's rates. That these considerations occur in the context of a complaint case does not alter the need to adopt an appropriate starting point. The Commission has adopted and utilized the year-ended point in time method for establishing a revenue requirement and finds it remains appropriate in this case. Whether adjustments to the test year are appropriate as proposed by the parties will be addressed on an issue by issue basis.

The Commission has determined further that a true-up as proposed by SWB is not warranted by the circumstances in this case. The evidence indicates that the effects of inflation on SWB's costs will be minimal and that growth in revenues will continue through this period. True-ups in the past have been utilized to offset the effects of inflation and the delay in implementation of rates caused by regulatory lag. Even though the delay in implementation of rates in this case may be longer than usual, the mere delay in implementation does not render the rates unreasonable. Revenue growth and Company management decisions could offset any increase in costs caused by inflation.

The Commission specifically rejects the true-up proposal of SWB at the hearing. The effect of a true-up as proposed would be an entire reauditing of SWB operations and thus a substantial delay in the implementation of new rates. If the Commission adopted a true-up as proposed by SWB it could never set new rates, since there would always be need for a true-up. The Commission must base its decision on data at some point in time. The Commission has determined the 1987 test year, as adjusted, is appropriate in this case. The Commission has determined it can make an intelligent forecast on that basis and it would be inappropriate to use 1988 actual data without an audit to determine if the 1988 data maintained the appropriate revenue, expense, and investment relationship.

B. <u>Annualization/Year Ending</u>

As part of its analysis of SWB's cost of service, Staff reviewed the revenues, expenses and investment levels of SWB. Staff made annualization adjustments to specific elements of SWB's cost of service to account for what Staff saw as certain trends in some of these elements. For revenues, Staff made annualization adjustments for the revenue for each product by calculating the average monthly rate per unit and then multiplying that average monthly rate by the December 1987 level of units and then by twelve, except for intraLATA toll revenues.

Staff's intraLATA toll revenues calculation is based upon the growth in toll minutes of use for each month in 1987 over the same month in 1986. Staff used this method for annualized intraLATA toll revenues because intraLATA toll revenues did not increase steadily each month, they fluctuated. Staff's method attempted to capture this fluctuation rather than using the year-end levels used for other revenue annualizations which exhibited constant trends.

For expenses, Staff annualized SWB's payroll for management and nonmanagement employees. Staff used year-end levels and wage rates at December 1987 times twelve to arrive at its straight time annualized payroll. For temporary employees, Staff used the actual amounts paid these employees during the test year prorated to Missouri. For occasional and part time employees, Staff calculated the dollar amounts paid by SWB during the test year. Staff also annualized overtime hours to arrive at an amount for total annualized payroll.

Staff also considered as part of this issue its calculation of the appropriate property tax expense for SWB. Since Staff is recommending a reduction in SWB plant and reserve in this case, and is recommending a decrease in SWB's rates, Staff has recommended the Commission use the actual 1987 property taxes booked by SWB in determining SWB's revenue requirement in this case. Staff makes this proposal based upon its stated inability to reliably determine an amount for property taxes using the Missouri State Tax Commission's three factor formula for its recommended revenue requirement in this case.

SWB presented its own recommendation concerning annualization of revenues and expenses. SWB proposes using a three-step method to develop end-of-period adjustments for revenues and expenses. First, SWB deflated monthly revenue levels to a constant price level, and adjusted expense levels to remove effects of changes in both wages/salaries and increased prices for nonwage expense. Revenues and expenses were expressed as if December 1987 levels and rates had been in effect throughout the test year.

Second, SWB adjusted the data to remove seasonal fluctuations. To accomplish this SWB used the U.S. Census Bureau's X-11 procedure. Finally, SWB treated the data to remove any remaining monthly irregular fluctuations.

Although this issue is addressed separately from the Test Year/True-up issue, the positions of the parties and their arguments indicate it is a continuation of that issue. SWB's brief concludes that a true-up would eliminate this issue.

The Commission has already determined that a true-up in this case is unwarranted and impractical. As with other items in SWB's cost of service, adjustments must be made to test year revenues and expenses to ensure they are set at a reasonable level and maintain the proper revenue-expense-investment matching.

Annualizing revenues and expenses, where appropriate, is a part of the process of developing the revenue requirement using an historical test year. The Commission does not consider SWB's proposal to use a single method for all revenue and expense items as a reasonable approach to determining the appropriate amounts of revenues and expenses to include in the cost of service. An analysis must be made of revenues and expenses to determine whether year-end levels are representative of the levels that can be expected to occur when the rates are in effect.

SWB's approach would remove this analysis and apply a "cookie cutter" approach to determining these levels. The Commission finds that the X-11 seasonal fluctuation has not been shown to be appropriate for rate case determination of revenue and expense levels. X-11 is used to adjust the unemployment rate, Gross National Product and Consumer Price Index. Although appropriate for those analyses, the Commission is not convinced it is appropriate for ratemaking determinations.

The Commission has determined that Staff's approach is reasonable as it analyzes revenues and expenses to determine trends and then makes annualization adjustments to account for those trends. Although SWB criticizes Staff's method as not reflecting the true trend in intraLATA toll revenues, a comparison of Staff's revenue level with 1987 and 1988 actual indicates it is a more reasonable level than SWB's. Staff's method may not track the actual fluctuations, but it does account for them and is a more reasonable approach than that proposed by SWB. This is also true of Staff's other revenue levels and expense levels. Staff's annualization adjustments recognize the general trend that SWB revenues are increasing and the general trend that SWB expenses are decreasing.

The Commission has also determined that Staff's annualizations for wages and salaries is reasonable. This is the method used by Staff in recent cases and SWB has not shown that this method is inappropriate or sets the wages and salaries at unreasonable levels.

The Commission determines further that Staff's use of the 1987 actual property taxes is reasonable. Based upon the Commission decision in this case reducing SWB's rates, it is reasonable to use the 1987 property taxes in arriving at a determination of SWB's revenue requirement.

C. TRA Credits

By settlement in Case No. AO-87-48, SWB agreed to provide a credit to local residential subscribers from July 1, 1987, to June 30, 1988. The credits total approximately $15 million on an annual basis. As a part of SWB's TeleFuture 2000 proposal, which was consolidated with this case, the credits were extended until June 30, 1989. The dispute between Staff and SWB is whether the effect of the credits on test year revenue should be eliminated.

This issue is another dispute over what adjustments should be made to the 1987 test year. Here the Commission is faced with a known and measurable change which will occur on July 1, 1989, when the credits end. The Commission finds it reasonable to adjust SWB's revenues to include the $15 million. The credits are interim and will expire, with a concurrent increase in SWB's revenues. The Commission cannot reasonably ignore the interim nature of the credits. The rates set in this case will be in effect for the period beyond July 1, 1989, and so should reflect the revenues SWB will receive from the termination of the credits.

D. Comptroller's Fix 1.0 Billing System (CF.1)

This issue arose originally as a result of two factors. The first factor is that on May 4, 1984, the United States District Court, District of Columbia, ordered SWB to implement a billing system which would permit accurate billing and allocation of revenues based upon actual interLATA and intraLATA 800 usage. This requirement was waived pending the development by SWB of the billing system.

The second factor is that when SWB was ready to implement the billing system, it was subject to the moratorium on rate increases from the settlement in Case No. TR-86-84. Since SWB could not raise rates because of the moratorium it did a usage study, which estimated that SWB would receive a $1,299,660 annual net increase in revenues once the new billing system was implemented. The study averaged three months of usage: February, March and May 1987.

SWB filed tariffs in Case No. TR-88-88 to implement the new billing system. SWB also filed tariffs to reduce 800 access rates a concurrent amount so there would be no rate increase in violation of the moratorium.

Case No. TR-88-88 was consolidated with Cases No. TR-88-99 and TR-88-197. TR-88-99 proposed changes in AT&T's (AT&T-Com's) tariffs to correspond to SWB's proposed tariffs and TR-88-197 was a tariff filing by AT&T (AT&T-Com) for a directory assistance charge of 70¢ to be implemented with the other proposed tariffs.

The Commission rejected all of the tariff filings in its Report And Order issued July 12, 1988. The Commission held that revenue increases such as the one which results from implementation of the CF.1 billing system were best addressed in a case involving SWB's general revenue requirement. PC has proposed that the $1,299,660 be included as revenue in this case to account for the implementation. MCI supports PC's position while SWB opposes the inclusion of the revenue in this case. SWB asserts that since CF.1 was not implemented until September 1, 1988, it is outside the test year in this case.

The Commission has already addressed this matter in Case No. TR-88-88. The Commission rejected any reduction to other rates in that case because it was outside the scope of a general rate case where the Commission could weigh all relevant factors. There is no question that CF.1 has been implemented, nor is there any question that the only evidence concerning the effect on SWB from the implementation of CF.1 is that SWB revenues would increase an estimated $1,299,660 annually. Although the test year in this case is calendar year 1987, the Commission may look to occurrences which are known and measurable outside of the test year in order to establish a reasonable revenue requirement for SWB for the period the rates approved in these proceedings will be in effect.

The implementation of CF.1 billing is a known and measurable occurrence. The study upon which the excess revenue was calculated used usage data from three months in 1987. The Commission has determined it is reasonable to include the excess revenue generated from the implementation of CF.1 billing in these proceedings as an out of period adjustment. The Commission indicated in its Report And Order in TR-88-88 that it would address this issue in the anticipated general rate case. The complaints by Staff and PC are general rate cases. Since there is no other evidence of the amount of any revenue increase received by SWB, the Commission finds the $1,299,660 is the reasonable amount to be included in SWB's revenue in these proceedings.

E. Part 32

On May 15, 1986, the FCC replaced Part 31 and 33 with Part 32 as the Uniform System of Accounts (USOA) for Class A and B telecommunications companies under Federal Communications Commission (FCC) regulation. SWB is a Class A telecommunications company. This Commission adopted Part 32 to replace Part 31 and 33 for accounting purposes for telecommunications companies operating in Missouri. 4 CSR 240-30.040. The Commission, in the comments filed with the Order Of Rulemaking adopting 4 CSR 240-30.040, specifically withheld approval of Part 32 accounting procedures for ratemaking purposes. The Commission stated it would address whether to adopt Part 32 for ratemaking treatment in general rate case proceedings. ALLTEL in its brief suggests the Commission does not have the discretion under Section 392.210.2, R.S.Mo. (Supp. 1987), to use a different method for ratemaking than approved for accounting. The Commission has determined it has the necessary authority to make such a decision.

Part 32 made significant changes in the allocation of certain costs between capitalization and expensing. With this change in allocations, expense accounts under Part 32 will not be comparable to historical expense accounts. Part 32 also requires the acceptance of Generally Accepted Accounting Principles (GAAP) and implementation of Financial Accounting Standards (SFAS) Nos. 13, 43 and 87.

Although other factors may influence the Commission's decision, Staff and SWB have agreed that the primary focus should be whether costs recognized under Part 32 are reasonably chargeable to current customers or whether such costs are more appropriately chargeable to future customers. Staff's evidence focused on the salaries and expenses of SWB executives which had been capitalized under Part 31 but which would be expensed under Part 32. Staff's evidence showed that these executive officers spend some or all of their time reviewing capital budgets or other issues related to construction projects. Staff contends these costs provide future benefit and so should be capitalized.

In order to treat SWB costs differently for ratemaking than for accounting, Staff proposes the Commission order SWB to maintain a surrogate so the capital to expense shifts required by Part 32 can be tracked. This surrogate would require substantial side records to be kept. Staff points out that SWB keeps side records for other items and the difficulty or cost of keeping these side records should not be the determinative factor.

The Commission, as stated earlier, has the authority to establish separate ratemaking treatment for costs than those required by Part 32. The Commission, though, in establishing separate treatment must look to the overall effect of that decision, as well as the specifics of certain cost shifts. The Commission has determined that based upon the review of the evidence in this record and the changes occurring in the telecommunications industry in Missouri, that it is more reasonable to adopt Part 32 procedures for ratemaking treatment in this case.

Part 32 brings SWB's accounting procedures more in line with competitive companies, thus making SWB better able to meet the requirements of a more competitive industry. In Case No. TO-89-56 SWB has requested that most of its services other than basic local service be declared transitionally competitive, with the potential of relaxing regulation on certain of SWB's services. If this occurs, Part 32 is a more appropriate costing procedure than a surrogate or side record.

The Commission is not convinced that an acceptable surrogate can be maintained by SWB. The data used in the surrogate, as time passes, would become more unreliable and the cost and expense of keeping the side records might eventually outweigh any benefit achieved. The capital to expense shifts will increase revenue requirement in the near term but the long term effect will not be any greater to customers. The Commission may agree with Staff on particular capital to expense shifts required by Part 32, but Staff's evidence on the salaries and expenses of executive officers was not convincing. A portion of these salaries, associated with SWB executives Mitchell, Castle and Dickerson, will still be capitalized. The salaries of SWB executives Barron and Denneny will not be capitalized as they were under Part 31. The Commission has determined there is a reasonable basis for this change since these two executives' salaries would be a part of SWB's costs even if SWB had no construction budget.

Although not the primary determining factor, the Commission considered the fact that the shift of costs resulting from the adoption of Part 32 for ratemaking purposes occurs within the context of a case to reduce SWB's rates. Since the Commission in this decision will be reducing SWB's rates, it can allow the implementation of Part 32 for ratemaking treatment without a concurrent rate increase. Other local exchange companies (LECs) may seek implementation of Part 32 for ratemaking purposes in future rate cases. The Commission will have to review those decisions individually in the context of each LEC's overall revenue requirement.

F. Separations/Part 36

Staff and SWB, as well as other parties, agree that the revenue requirement to be determined in this case must recognize the costs associated with jurisdictional shifts caused by separations changes adopted by the FCC. These shifts occur through changes in separations allocations and by adoption of Part 36. Staff calculates these costs to be approximately $5 million while SWB calculates these costs to be approximately $13 million for changes from Part 31/67 to Part 32/36 and approximately $2.6 million in separations changes. Staff contends its $5 million contains all of the shifts in separations, CPE phase-in and gross allocations changes, required by FCC actions and by adoption of Part 36.

Staff calculated the $5 million by taking 1987 forecasts and comparing the aggregate amount using the Part 36 allocations with Part 31/67 allocations. By comparing these amounts in the aggregate, Staff calculates the $5 million difference.

The Commission has determined that Staff's calculations do not account for all of the effects of the adoption of Part 36 and separations changes. The changes between Part 31/67 and Part 36 are so significant that taking an aggregate figure will not account for the total separations shift to intrastate. Staff was not able to identify what portion of its $5 million related to CPE phase-in and gross allocations and what portion was the result of Part 36 changes.

The Commission has determined that SWB's evidence concerning the additional amounts allocated to the interstate jurisdiction caused by Part 36 are more accurate. The intrastate amounts should correspond to interstate amounts so that 100 percent of SWB's expenses may be recovered. The Commission has determined, based upon the evidence in this case, that SWB's calculation of the intrastate portion which results from the separations and Part 32 shifts is reasonable. The actual number associated with these shifts is shown in the Summary section. The Commission has determined that SWB shall be authorized to include this amount in its COS to reflect the cost shifts which result from implementation of Part 32/36 and separations.

G. Income Taxes

There are several subissues involving the calculation of the proper level of SWB income taxes which are disputed by Staff and SWB. These issues are: (1) amortization of investment tax credit and tax rate change; (2) pre-1981 cost of removal and gross salvage; (3) vacation pay; (4) business meals; (5) capitalized interest; (6) interest deduction; and, (7) normalization.

1. Amortization of Investment Tax Credit (ITC) and Tax Rate Change

Staff, in calculating its position on the proper level of amortization of ITC associated with SWB plant and the proper level of amortization of the excess deferred income taxes associated with reduction of the federal income tax rate, used amounts which included total SWB-MO plant in service. These amounts were received from SWB in response to DRs and included amounts associated with net compensable property.

Another aspect of net compensable property is also discussed elsewhere in this Report And Order. Net compensable property is property which is located in Missouri but is used to provide service to customers in other states. This property is removed from SWB-MO's rate base for purposes of calculating SWB-MO's revenue requirement.

SWB contends that since the net compensable property is removed from rate base, the ITC and amortization of excess deferred taxes associated with that property should also be removed. The Commission agrees.

The evidence is that Staff accountants did not consider removing these amounts until SWB raised the issue. Staff witnesses then testified the moneys should not be included because in the past normalization of SWB's tax deductions increased the rates paid by ratepayers and the amortizations return that money to customers by reducing rates. Staff contends the money is owed ratepayers regardless of how plant investment is treated.

The Commission has determined that consistent treatment of net compensable property requires that the amounts of excess tax depreciation and ITC should be removed in calculating SWB's income tax.

2. Pre-1981 Cost of Removal (COR) and Gross Salvage

Staff in calculating the appropriate level of SWB taxes did not reduce the balance of deferred taxes for the COR and salvage which had been previously flowed through. SWB contends that customers have already received the tax benefit of the timing difference between tax depreciation and book depreciation and will receive the tax benefit a second time if Staff's position is adopted.

Staff contends that an adjustment to deferred taxes for deferred income taxes associated with pre-1981 COR and gross salvage is only necessary if aggregate salvage was higher than COR in book depreciation. Staff's evidence indicates that aggregate COR is higher than salvage and depreciation.

The Commission has determined that no adjustment need be made to reduce the balance of deferred taxes for deferred income taxes associated with pre-1981 COR and gross salvage. Staff's evidence shows there are negative net salvage amounts for the years in question and so the adjustment is unwarranted. The Commission finds that Staff's position is appropriate.

3. Vacation Pay

As a result of a change in the tax law, SWB changed its accounting for vacation pay from accrual to an expense basis and so certain portions of vacation pay expenditures were deducted twice for tax purposes. SWB was required to increase taxable income over four years beginning January 1, 1988, to account for this double deduction. The amount amortized over four years is a percentage of the net of December 31, 1987 vacation pay timing difference less the December 31, 1973 suspense amount.

Staff did not make an adjustment to SWB's income tax to account for the increase in taxable income associated with this change in the tax law. Staff's position is that although SWB must now pay taxes on this amount, SWB had in past years taken deductions on the amount now being amortized. Staff witness Rackers testified that those deductions were not reflected in SWB's COS and so it would be inappropriate to include the amortization in the COS in this case.

The Commission has determined that the COS in this case should reflect the tax timing differences for vacation pay required by the new tax law. The cross-examination of Staff witness Rackers indicated he had not reviewed Section 481 of the Internal Revenue Code and was not aware of its requirements. Staff's position that no adjustment is appropriate is not reasonable. The new tax law requires SWB to increase its taxable income to account for the double deduction. The Commission has determined it would be allowing a double benefit to ratepayers not to include this increase in SWB's COS.

4. Business Meals

Staff has eliminated the cost of business meals from its COS calculation because no records exist which can be used to verify the need for these expenses. This eliminates the need to make an adjustment to SWB's COS for the nondeductible portion of business meals.

The evidence in this subissue indicates that SWB had problems with procedures, supporting documentation and accountability associated with business meals. Over half of vouchers sampled in one audit report contain errors and a large percentage of vouchers failed to contain adequate support for the expense. Based upon this evidence, the Commission has determined Staff's elimination of the cost of business meals from SWB's COS is reasonable.

5. Capitalized Interest

Section 263(A) of the new tax law requires the capitalization of interest related to certain construction projects. Staff did not add back to taxable income the amount of interest capitalized for tax purposes that was expensed on SWB's books. SWB contends this add-back should have been made.

This issue is separate from the interest synchronization issue since this subissue involves interest related to construction projects while interest synchronization relates to rate base. The Commission has determined that recognition of the interest on certain construction projects is reasonable and is proper under Section 263(A).

6. Interest Deduction

This subissue involves the interest synchronization issue which the Commission has addressed in previous cases. Interest synchronization is the synchronization of a tax deduction for interest with the interest the ratepayer is being required to provide SWB through rates. The calculation is made by multiplying the rate base by the weighted cost of debt used in the determination of the cost of capital.

SWB has proposed a method for calculating this interest by removing ITC from rate base prior to multiplying the rate base by the weighted cost of debt. This method is not appropriate. The appropriate method calculates the tax effect of the interest expense paid by ratepayers in rates. This calculation is made by multiplying the rate of return as determined by the Commission in this case times the rate base in this case.

7. Normalization

Because of the adoption of Part 32 (discussed elsewhere) SWB asserts that an additional $1.7 million is required in its COS to account for capital to expense shifts. Staff opposes this additional revenue requirement.

Staff views this subissue as an attempt by SWB to put in place full normalization, which has not been approved by the Commission. SWB sees this issue as the implementation of Part 32. The Commission has addressed implementation of Part 32 in a separate section of this Report And Order. In that section the

Commission has adopted Part 32 for ratemaking purposes. The adoption of Part 32 has with it a corresponding amount which will be made a part of the revenue requirement in this case. The Commission has determined that the additional adjustments proposed by SWB in this issue are not appropriate.

H. Employee Compensation

The Staff is proposing a reduction of test year expenses in the approximate total amount of $27,420,000 representing alleged unjustified and unreasonable levels of employee compensation. The proposed adjustments include the applicable FICA Tax.

1. Management and Senior Management Base Salaries

The Staff's proposed reduction in operating expenses representing alleged excessive management salaries is in the amount of approximately $9,553,000. It is the Staff's contention that SWB's goal of compensating employees at a 75th percentile level is unnecessary and unjustified.

Shortly before divestiture SWB established a policy of compensating its employees at the 75th percentile level to be effective following divestiture. Prior to divestiture AT&T negotiated all management and nonmanagement compensation on a national basis.

Compensation at a 75th percentile level means the company's goal is to compensate its employees at a level which will be at or above 75 percent of the companies with which it competes for employees, and below 25 percent of those companies. Management salary increases are set by senior management and are based on a study comparing salaries with other companies using a Hay Management Consultant (Hay) Survey. In 1987 the Hay study compared SWB's salaries with those of 36 companies participating in the study. Although the Hay study was of total compensation, including incentives and bonuses, the proposed Staff disallowance pertains only to base salaries.

The Staff attacks the compensation level alleging that the goal of compensation at the 75 percentile level is unjustified and unnecessary. The compensation level is also criticized because it differs from the compensation goal of other utilities in the area such as Union Electric Company, St. Louis County Water Company and GTE North Incorporated.

It is the Staff's position that because SWB's compensation goal is different it requires clear justification. Factors contributing to the Staff's contention of unreasonableness include lower than average turnover rates, a surplus of promotable employees, and the absence of any study or analysis to determine the effects of paying employees at a lower level. Staff also criticizes the absence of any management performance appraisal plan to judge the effect of the compensation plan on increased productivity.

In the Commission's opinion the Staff's evidence falls short of being persuasive toward the disallowance in several respects. The Staff's criticism of a different compensation goal from that of other utilities is flawed because of an inexact comparison. UE's goal of compensation at the 50 percentile level was based on a comparison of other electric utilities earning comparable revenues nationwide. As previously stated, SWB's survey under criticism was of companies operating in SWB's service area believed to be its direct competitors for human resources. In fact, there is no information available concerning the actual salary levels of any SWB, UE, St. Louis County, or GTE employee of comparable skills and responsibilities. It is unknown whether or not SWB pays more or less than UE for comparable skills or responsibilities.

During the hearing it was learned that SWB had, just a few days earlier, received the results of the 1988 Hay study of communication companies only. Some of the companies in the nationwide communication compensation study were other RBOCs. The recent communications study was revealed in response to Staff questioning. Although SWB had received the recent study after the filing of its rebuttal testimony, an objection was sustained as to the offering of the study. Since the Staff was given a continuance of approximately one week to prepare cross-examination on the study, the claim of surprise or lack of preparedness on a new issue has been cured. The ruling to sustain the objection is reversed and the recent Hay study (Exhibit 75HC) should be, and is, received in evidence. The new Hay study of communication companies establishes that SWB is compensating its employees at approximately the 50th percentile level when compared with other communication companies nationwide. The recent communication study is more similar in nature to the study on which UE's salary levels have been established.

In the Commission's opinion the reasonableness of SWB's goal is insignificant if the goal is not being reached. Also in the Commission's opinion the evidence of compensation levels actually being experienced falls short of proving that the compensation levels are unreasonable and unjustified.

2. Nonmanagement Wages

The Staff proposes to disallow approximately $5,144,000 of test year operating expenses as representing unwarranted or unjustified compensation concessions in negotiation of SWB's 1986 labor contract for nonmanagement wages. Although the 1986 collective bargaining agreement covered wages for a three-year period commencing in August, 1986, the Staff is not proposing any adjustment in the union wage increases granted beyond the test year ending December, 1987. The Staff primarily proposes the disallowance because SWB's own 1986 prebargaining Hay study ranked SWB's wages at the 90th percentile level whereas SWB's objective was to be at the 75th percentile wage level.

The Staff's proposed disallowance of collective bargaining benefits appears to be based on a number of mistaken assumptions. SWB's evidence establishes that, at the time of divestiture, it inherited wage levels, previously negotiated by AT&T, which SWB's senior management considered excessive. 1986 was the first time that SWB negotiated with the Communication Workers of America (CWA) on its own. Witnesses of both SWB and CWA indicated that the labor negotiations were both intense and adversarial. SWB initially proposed a zero wage increase; however, that proposal was unacceptable to CWA. In addition to wage negotiations the 1986 bargaining covered a number of demands which SWB's senior management felt would erode its ability to control SWB's affairs. The entire collective bargaining agreement was a compromise between wage concession and retention of management rights.

SWB's 1986 labor agreement was concluded on a monetary basis more favorable than the 1986 agreement of AT&T and more favorable than the average of the other RBOCs. A number of the rejected management demands would have been more expensive than the wage concessions granted.

Finally, it should be noted that the reasonableness of SWB's 75th percentile goal is immaterial if it is impossible for SWB to reach that goal as a result of the high wage levels inherited at divestiture. Because of the relatively high tenure of SWB's employees, the wage levels are further inflated by virtue of many of those employees being at the top of a wage range. In the short run the only way for SWB to reach even its goal of 75th percentile would be to effect wage reductions. In light of the intensity of the 1986 negotiation, that likelihood was quite remote. In the Commission's opinion it cannot determine that SWB has been imprudent in its wage concessions and the proposed nonmanagement wage adjustment should not be allowed.

3. <u>Management Transitional Program (MTP)</u>

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

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

4. Supplemental Income Protection Plan (SIPP)

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

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

SWB resists the adjustment, contending that it assumes net reduction in employees whenever SIPP is paid, while in reality employees in one location may be declared surplus even though SWB adds similar jobs in another location. If this condition is true it appears that the entire SIPP program is a failure if the additional payments do not result in the intended purpose of a net reduction in work force. Test year SIPP payments are the highest level since 1984 and in the Commission's opinion the Staff's proposed disallowance should be approved.

5. Team Effectiveness Award for Managers (TEAM)

The Staff proposes a disallowance of approximately $4,772,000 of TEAM payments which are perceived to fail to comply with the Commission's stated policy covering management incentive plans. In the Commission's opinion the record does not support the reasonableness of the proposed adjustment and it should be rejected.

SWB's stated purpose for TEAM is to place a portion of management employees' total compensation "at risk" so that it must be earned every year rather than being embedded as base salary. Each year top management establishes a target award amount which can be received if the net income and customer satisfaction goals are met. The customer satisfaction goal is the percentage of the customers expressing the opinion that SWB's service is either good or excellent as established by inquiry during customer contacts. For a high level of performance in both categories, 150 percent of the target award may be earned.

For purposes of the program SWB is divided into six teams consisting of the five states in which it operates and general headquarters. The Staff has applied the yardstick previously stated by the Commission as follows: at a minimum, an acceptable management performance plan should contain goals that improve existing performance and the benefits of the plan should be ascertainable and reasonably related to the incentive plan. RE: Staff v. Union Electric Company, 29 Mo. P.S.C. (N.S.) 313, 325 (1987). Staff levies a number of criticisms of the plan including the fact that it does not penalize for underachievement and does not recognize individual contribution. The plan is also criticized because the net income goal only benefits shareholders and the service objective may actually be lower than for the prior year in any given state. The goal is established as the average of the prior year's level in the five operating states.

In the Commission's opinion SWB is correct in its contention that the Staff misunderstands the nature of the TEAM award. The award is not a bonus or additional compensation for superior performance but is a substitute for expected increases in base salary which in recent years have been exchanged for the TEAM award which must be reearned every year. It should be recalled that the total compensation, including incentives, is currently tracking approximately the median of communications companies. SWB is relying on what it perceives to be the best current compensation doctrine of the best managed companies in the nation. All of the companies responding to a survey by Coopers & Lybrand conducted on behalf of SWB indicated the use of annual incentive programs with more than 85 percent of those companies using a TEAM factor rather than an individual basis.

In the Commission's opinion SWB should not be faulted for following the advice of experts in the compensation field and it is not unreasonable to base the incentive plan on the achievements of the company rather than individual efforts. The TEAM payments represent a relatively small portion of total compensation and offer a prospect of increasing the reward for higher levels of achievement.

It is SWB's belief that the TEAM awards are partly responsible for increasing the customer's perception of the quality of service since the time of divestiture. At that time approximately 52.2 percent of the customers perceived the service as good whereas the same assessment is now made by approximately 82.9 percent of the customers.

Since we are unable to find that the total compensation level is excessive, the TEAM awards are reasonably calculated to encourage company-wide performance and the proposed disallowance should be rejected. In the Commission's opinion the benefits of the plan are reasonably ascertainable and related to the plan.

6. Senior Management Short Term and Long Term Incentive Plans

The Staff proposes an additional disallowance of incentive plans providing for payments to senior managers above the level of those employees eligible for TEAM. All of Staff's criticisms of the TEAM awards are applicable to the short term and long term incentive plans. The period covered by the short term plan is one year while the period for the long term plan increases to three years.

Short term plans are based in part on the performance of SBC and other states' operations of SWB. A long term plan is based on SBC's financial results.

The testimony in support of the incentive plans cited in SWB's brief, as is the brief itself, is largely devoted to the defense of the TEAM awards with little separate mention of the long term and short term incentive plans. In SWB's reply brief there is no response to the Staff's additional criticism of the short term and long term incentive plans in the Staff's initial brief.

In the Commission's opinion the results of the parent corporation, unregulated subsidiaries, and non-Missouri portions of SWB, are only remotely related to the quality of service or the performance of SWB in the state of Missouri. Achieving the goals of SBC and unregulated subsidiaries is too remote to be a justifiable cost of service for Missouri ratepayers. Accordingly, the Staff's proposed disallowances in the senior management's long term and short term incentive plans in the respective amounts of approximately $563,000 and $829,000 should be adopted.

7. Concession Telephone Service

The Commission Staff proposes to adjust the test year expenses by an amount that could be realized if SWB discontinued giving both management and nonmanagement employees and retirees discounted telephone service. Telephone concessions include not only discounts for basic service but also custom calling features, touch tone, inside wire, access charges and intraLATA toll service. The Staff concedes that Section 392.220, R.S.Mo. (Supp. 1988), provides for discounted telecommunications services but the Commission is not required to pass through the cost of such service into rates. The Staff contends that discounts for telephone service are not necessary to the provision of utility service and should be disallowed as expenses since the cost does not benefit the ratepayer.

SWB has provided concession telephone service to active employees since 1919 and to retired employees since 1946.

As pointed out in SWB's brief, the Commission in Case No. TR-82-199 rejected a similar adjustment and stated:

> [A]ny savings realized from the elimination or reduction of the discounted telephone service benefit is likely to be more than offset by higher wages. The provision of such employee discounts over the past 63 years has become a custom and practice which, under federal labor law, may now be binding on SWB. Were the discounts reduced or eliminated, that change would have to be

negotiated with the Union. Equivalent cash compensation would cost Southwestern Bell $1.68 for each dollar's worth of discounted telephone service provided to non-management employees, because of the effect of additional social security taxes, pension and other benefit payments.

In the instant case the only new argument advanced by the Commission Staff was that concessions previously given to employees of unregulated subsidiaries or the parent corporation and Southwestern Bell Yellow Pages, Inc. had been discontinued and had not been replaced with any other form of compensation. SWB's evidence established that the parent corporation and the other subsidiaries reimburse employees for the same concessions provided by SWB, thereby becoming more expensive than SWB's concessions because of the tax consequences.

The Commission still agrees with SWB's contention that the longstanding telephone concessions are reasonable and that a disallowance of those concessions would result in demands for higher wages to replace the lost benefit. We are not persuaded by the instant record to depart from our longstanding allowance of telephone concessions.

I. Cash Working Capital

SWB and Staff agreed to the lead/lag factors to be used in calculating the appropriate amount of cash working capital (CWC) for inclusion in rate base. Staff and SWB disagree concerning what line items should be included in the CWC calculation. It is Staff's position that CWC applies only to line items which represent ongoing outlays of cash by SWB necessary for the provision of service. It is SWB's position that depreciation, deferred taxes and net operating income (NOI) should be accounted for in the CWC calculation. SWB calls its calculation a calculation of working capital rather than just cash working capital.

The Commission has addressed this issue before in several cases. See Exhibit 94, p. 10. The Commission has consistently held that the purpose of the CWC calculation using lead/lag studies is to determine the cash necessary on a day to day basis to provide service and to determine who supplies this cash. A positive CWC requirement indicates that, in the aggregate, the shareholder provided the CWC and a negative CWC requirement indicates that, in the aggregate, the ratepayer provided the CWC.

The Commission has not considered it reasonable to include noncash items such as depreciation and deferred taxes in CWC since they do not represent a current cash outlay by a company. The Commission has treated CWC on a cash basis rather than accrual. Depreciation and deferred taxes are entered on SWB's books on an accrual basis and so are not appropriate items to be used in calculating the amount of cash SWB needs to maintain its day to day operations.

The Commission has also not included NOI in CWC. NOI is not a cash expense, it is the return paid on investors' interest. SWB's proposal would treat this return on the equity investment of investors the same as the interest on SWB's debt. As testified to by Staff witness Oligschlaeger, debt interest requires a mandatory cash outlay, while the return on equity is not mandatory and the only cash outlay involved are the dividends which SWB pays. The dividends are not mandatory and they are paid out subsequent to receipt of the cash. If included, dividends paid would reduce the CWC requirement.

Based upon the foregoing, the Commission has determined that Staff's calculation of CWC is appropriate.

J. Complex Inside Wire

Complex inside wire (CISW) is the wire used by key and PBX customers between the customer's individual station equipment and the common telephone equipment on the premises. CISW was capitalized on SWB's books until 1981. In 1981 the Federal Communications Commission and this Commission authorized SWB to amortize the capitalized investment over a ten year period.

In SWB's divestiture case, TR-83-253, the Commission approved an SWB tariff which charged the owner of the common equipment for the use of SWB's CISW. RE: Southwestern Bell Telephone Company, 26 Mo. P.S.C. (N.S.) 442, 466-467 (1983).

Customers could avoid this charge by purchasing the CISW from SWB or installing their own CISW. AT&T owned the majority of the common equipment which it leased to its customers.

AT&T appealed the Commission's decision approving the tariff. The Commission's decision was upheld by the Missouri Western District Court of Appeals. State ex rel. AT&T v. PSC, 701 S.W.2d 745 (Mo. App. 1985). While appealing the Commission decision, AT&T made no payments to SWB for use of the CISW. AT&T also withheld payments for similar charges in Kansas, Oklahoma and Arkansas.

SWB filed suit in the federal district court in Kansas against AT&T to recover the payments for use of the CISW. AT&T and SWB settled the lawsuit on October 1, 1985. As part of the settlement agreement AT&T agreed to purchase the CISW in the four states. The purchase price for the CISW was less than the amount on SWB books associated with the CISW.

It is Staff's position that depreciation reserve should be increased to remove the effect of the difference between the purchase price and the booked amount, and amortization expense should be adjusted to remove the effect. The adjustments are proposed so that the revenue requirement associated with the CISW sold to AT&T should not be included in setting rates in this case.

It is SWB's position that the sale price for the CISW was within guidelines approved by the Commission in TR-83-253 and was a reasonable settlement of the federal court litigation.

Although there has been a substantial amount of evidence on this issue related to whether SWB used the proper pricing method for setting the purchase price for the CISW, the real issue is how to treat the difference between the sale price and the booked amounts for revenue requirement purposes. SWB can no longer recover the difference from AT&T. If the difference is to be recovered in rates, it will have to be recovered from other customers.

The regulatory treatment of sales of assets by utilities under the Commission's jurisdiction has been addressed in other cases. RE: Missouri Cities Water Company, 29 Mo. P.S.C. (N.S.) 178 (1987); RE: Missouri Cities Water Company, 26 Mo. P.S.C. (N.S.) 1 (1983); RE: Associated Natural Gas Company, 26 Mo. P.S.C. (N.S.) 237 (1983); RE: Kansas City Power & Light Company, 21 Mo. P.S.C. (N.S.) 843 (1972). Even though the Commission has indicated in these cases that a showing of the gain on the sale of utility property used in provision of service should be considered on a case by case basis, the Commission has consistently treated the gain below the line. This is true whether the property was land or depreciable property. In the latest Missouri Water Company case, the Commission held that there was little difference between contributed property and depreciable property and the ratepayer, in each case, had only a reasonable expectation of service and not an interest in the property. RE: Missouri Water, 29 Mo. P.S.C. (N.S.) at 183. The Commission cited Reinhold v. Fee Fee Trunk Sewer, Inc., 664 S.W.2d 599 (Mo. App. 1984) to support this decision.

The Commission has determined the sale of the CISW to AT&T comes within the reasoning of the cases cited above. Any loss or gain from the sale is to be treated below the line. In addition, the customers who used the CISW can no longer be charged and it is not reasonable to charge the other ratepayers for these costs. The Commission gave SWB an opportunity to recover through amortization the costs associated with CISW. SWB decided instead to sell the CISW to AT&T at less than book and so it should absorb the difference between the sale price and the unamortized amounts on its books. The Commission finds that Staff adjustments are reasonable, but should be calculated based upon the depreciation reserve and amortization as of June 30, 1989. By calculating these amounts as of June 30, 1989, the Commission is recognizing the continued amortization and thus will match the adjustments more closely with the amount carried on SWB's books at the time the rates go into effect.

K. Maintenance of Service Charge (MSC)

The Commission's Staff objects to SWB's imputation of MSC revenues and expenses associated with INLINE/INLINE PLUS (INLINE) customers to regulated (above the line) accounts. Although SWB's tariffs now use the term Customer Owned Equipment Trouble Isolation Charge (COETIC), MSC was generally used in the briefs, testimony, and Hearing Memorandum. MSC is a tariffed trouble isolation charge of $25 which is applied for each repair visit to a customer's premises if the trouble is found to be on the customer's side of the demarcation point. INLINE is an optional unregulated service provided as a prepaid maintenance plan to eliminate high customer repair bills as well as the MSC charge. If a customer pays the monthly INLINE charge, inside wire and customer premises equipment repair is performed including the use of a loaned telephone set for up to 60 days.

If an MSC charge is incurred by a non-INLINE customer the subscriber pays the $25 charge. If that same subscriber is also an INLINE customer the unregulated INLINE service makes the payment of $25 to the regulated revenues.

It is the Staff's position that the related costs of INLINE should be booked below the line with service revenues to prevent cross-subsidization of a deregulated service by a regulated service. It is also the Staff's contention that the actual cost of approximately $40 is the correct amount to impute rather than the tariffed charge of $25.

In the Commission's opinion SWB's method results in increased profits below the line because some unregulated costs are subsidized by the regulated revenues. The evidence establishes that efforts related to sales of the unregulated INLINE service are conducted by company employees during routine customer contacts. The expenses of the sales efforts are maintained above the line and charged to the account for which work was being performed at the time of the contact, unless the customer contact results in an employee being dispatched due to trouble in customer owned facilities. If the trouble is found to be in the network, the expenses of providing INLINE remain in the regulated accounts.

The Staff's proposal should be adopted since it will result in all of the costs incurred in promoting, as well as rendering, the unregulated service being charged to that service.

L. Pay Phone Installation Expense

In an order effective January 1, 1988, the FCC authorized telephone companies to expense the costs associated with the installation and removal of pay phones while capitalizing the direct costs associated with the equipment. SWB proposes the Commission adopt this same treatment of pay phone installation and removal for its Missouri operations. Staff opposes expensing these costs.

The evidence indicates that although the number of pay phones SWB has in service is growing, the replacement of pay phones has increased due to competition from private pay phone owners. When SWB replaces a pay phone the phone equipment can be reused, but the costs associated with installation and removal are one-time costs. Because the equipment can be reused, more than one installation and removal cost could be associated with each pay phone. Since competition now causes the more rapid replacement of the pay phone equipment, the Commission has determined that it is more reasonable to expense the installation and removal costs. The Commission has also determined that by expensing these costs, SWB can keep its administrative costs down since side records will not be required for Missouri operations.

M. Net Compensable Property

SWB has property located in each state which is used to provide service to customers in one or more of the other states where SWB provides service. SWB performs a study each year to determine how much each state must remit to each other state for the services provided. This study calculates maintenance, depreciation, property taxes and return on investment for the property used to provide service to another state. Staff and SWB have agreed on the amount to be eliminated from

Missouri revenue requirement except for two areas. One area is maintenance expense and property tax amounts, and the other is depreciation expense.

Staff has used the 1988 Net Property Compensation Study to represent the amounts for maintenance expense and property taxes associated with this property, and SWB proposes to use the averages of the 1987 and 1988 results. The Commission has reviewed the issue and has determined that the 1988 study results are more reasonable amounts to use for the maintenance expense and property tax to be used. The evidence is that the 1988 study is based on June 30, 1987, levels of investment, while the 1987 study is based upon 1986 levels. The Commission has determined the June 30, 1987, levels are more reasonable estimates of levels actually incurred in 1987. The evidence indicates SWB does not record the actual amounts.

Staff proposes to use Missouri depreciation rates for the Missouri property used for service in other states. SWB proposes using the depreciation rates from the other jurisdictions. The Commission has determined that the Missouri depreciation rates have been determined to be just and reasonable by this Commission and should be used. The Commission does not know nor has it made a determination concerning the depreciation rates of other states, and has determined it would be unreasonable to adopt those rates without a determination as to their reasonableness.

N. Billing and Collection

Tariffs reducing rates charged for billing and collection to interexchange carriers by SWB went into effect January 1, 1988. This decrease in rates will result in a loss of revenue from billing and collection of $6.5 million in 1988. Since the tariffs became effective one day after the test year, SWB proposes that the decrease in revenue be taken into account in determining the revenue requirement in this case. Staff opposes this based upon evidence which shows SWB will have an overall revenue increase in 1988 above Staff's proposed level of revenues. It is Staff's position that the increase in revenues will more than offset the revenue loss associated with the reduction in billing and collection rates.

The Commission has determined that the evidence showing the overall increase in revenues for SWB is persuasive. The evidence reveals that any loss due to the change in billing and collection rates will be offset by growth and by expense reductions. Although the Commission has taken into account some adjustments for occurrences beyond the 1987 test year in this case, the Commission has determined that the evidence concerning growth of revenues weighs against SWB's proposal to include billing and collection loss of revenue in its COS in this case.

O. Bellcore

Included in the proposed disallowances are approximately $326,000 in charges for services rendered to SWB by Bellcore, which is a wholly-owned subsidiary of the seven RBOCs. Each of the companies owns one share of stock in Bellcore.

The Staff proposes several disallowances because SWB has been unable to accurately or adequately quantify the benefits of Bellcore's services or the need for those services. The Staff proposes attribution of reduced return on equity for Bellcore and the elimination of consideration for deferred taxes, elimination of the gross-up factor, and the elimination of the unamortized investment tax credit.

The Staff has proposed to adjust Bellcore's rate of return from 14.5 percent to its recommended low rate of return in this case of 11 percent. The rate of return for Bellcore established by its Board of Directors for 1987 was based on the end-of-the-year average in 1986 of the authorized rate of return for all 49 jurisdictions which the seven regional companies operate.

The Staff has not been able to suggest any method of quantification of the benefits of individual projects and concedes that the cost of quantification may exceed the amounts involved. There has been no evidence offered of an excessive price paid for any service and it is conceded that there are very few vendors offering some of the services secured from Bellcore. In the Commission's opinion there is an inadequate basis for the proposed adjustment and it should not be accepted.

P. Deregulated Services

SWB performs certain functions for its subsidiaries that provide unregulated services. Those deregulated services consist of Improved Mobile Telephone Service (IMTS), Bellboy, and Inside Wire (ISW). The Staff adjustment for Bellboy is not at issue in this proceeding.

The parties agree that it is proper to remove from the cost of regulated service the investment, expense, and a reasonable contribution associated with the provision of deregulated service. SWB concedes that it is appropriate to require all services to produce some level of contribution to joint and common costs.

The proposed adjustment for IMTS and ISW in the approximate amount of $546,000 results from adding a proposed 17.5 percent contribution to the cost of IMTS as reflected by an SWB embedded direct cost study. The contribution level of 17.5 percent was selected by the Staff as the midpoint of the minimum contribution level of 15-20 percent required by SWB's affiliated transaction policy.

SWB in its testimony and brief attacks 17.5 percent as arbitrary and suggests 15 percent above incremental costs as a more appropriate contribution level. One SWB witness correctly states that the affiliated policy requires a minimum contribution of 15 percent above cost. Testimony of SWB witnesses appears, however, somewhat at odds when comparing the rebuttal testimony of SWB witness Powers to the effect that "the affiliate services pricing strategy is to generate the largest practical contribution ..." and that the contribution level of affiliate services has increased from a contribution rate of 27 percent in 1984 to 49.5 percent in 1987. During cross-examination Powers could recall no service priced at a minimum of 15 percent and stated that all services are priced to reflect a market-like condition, and the result in contributions have been greater than 15 percent.

In the Commission's opinion the Staff's proposed adjustment is not only reasonable but conservative and should be adopted for the instant determination of rates.

Q. Rate Case Expense

Public Counsel seeks a requirement that SWB keep records of the expenses associated with this case, and be precluded from recovering those expenses in future cases. It is PC's contention that failure to keep the requested records is a violation of a prior Commission order which stated: "That Southwestern Bell Telephone Company be, and is hereby, ordered and directed to keep accurate and detailed records segregating all of its expenses associated with Missouri intrastate rate case proceedings, including the specific items listed in Public Counsel's proposal in this case at Section IV.J. of this Report and Order." RE: Southwestern Bell, 25 Mo. P.S.C. (N.S.) 462, 545 (1982). There is no monetary adjustment connected with the PC's request.

SWB has not segregated the expenses connected with this case and contends that the requirement in Case No. TR-82-199 did not apply to cases not initiated by the company.

In Case No. TR-82-199 the Commission adopted the PC's proposal, which was justified in PC's brief filed in that matter as follows: "Rate case expenses are somewhat unique, however, in that they are incurred by utilities for the primary purpose of attaining rate relief. Consequently, when ratepayers pick up the tab for such expenses, they are, in effect, being required to finance the means by which their own rates are increased."

In the Commission's opinion it is not unreasonable for SWB to have interpreted the Commission's prior order as applying only to SWB-initiated actions. In the instant case the action was not initiated by SWB and does not contemplate rate relief. To the contrary, the action herein involved only contemplates a rate reduction; therefore, the primary perceived offense of forcing the ratepayers to finance their own rate increases does not exist. The Commission, therefore, cannot find that SWB is in violation of the order issued in Case No. TR-82-199.

R. Membership Fees, Dues, and Charitable Contributions

1. Membership Fees and Dues

The Public Counsel recommends the disallowance of a portion of SWB's payment for membership fees and dues ($224,150). PC proposes to allow certain other membership fees and dues ($204,000). The disallowed amounts are criticized by PC as being violative of one of the following: 1) involuntary ratepayer contributions of a charitable nature; 2) supportive of activities which are duplicative of those performed by other organizations to which SWB belongs or pays dues; 3) activities that provide no direct benefit or increase quality of service to the ratepayers; or 4) not necessary for the provision of safe and adequate service.

The PC has not inquired of SWB as to why it has membership in any of the organizations. Instead, the PC has read past Commission orders to ascertain the names of organizations in which memberships have been approved or disapproved. PC then used the sound of names of organizations receiving payments during the test year to arrive at the proposed disallowances.

The list of organizations to which memberships are proposed to be authorized consists primarily of local chambers of commerce throughout the state. The proposal has the rather anomalous result of disallowing the cost of membership in the State Chamber of Commerce as probably being duplicative of the efforts of local chambers of commerce, although the PC witness was unaware of the nature of the activities of any of the organizations. In a similar vein, the PC proposes disallowance of the membership in the United States Telephone Association while leaving undisturbed the membership paid to the Missouri Telephone Association because of the assumed duplication of efforts of the two organizations.

In the Commission's opinion the proposed adjustment is not supported by competent and substantial evidence and should be rejected.

2. Charitable Contributions

PC's proposed adjustment also includes one contribution of a charitable nature. It is still the Commission's opinion that no matter how laudable the purpose of the charitable organization may be, contributions should not be allowed for rate-making purposes since the ratepayers should not be made unwitting contributors to the charitable concerns preferred by the company. We have recently reiterated our opinion that the issue is not the worthiness of charitable organizations contributed to, but the fact that ratepayer dollars are flowed through to the organization, whether the individual ratepayer would have chosen to make the contribution or not. In Re St. Louis County Water Company, Case No. WR-88-5, Report And Order, p. 19 (May 27, 1988). Although the company may find it desirable to contribute shareholder dollars to worthy charitable causes, the company's rates should not include such contributions. PC's adjustment is adopted.

S. Parent Company Costs (SBC)

The Staff has proposed a number of adjustments because SWB has not adequately demonstrated that its purchases of products or services from affiliates are the best possible alternatives.

A portion of the Staff's proposed disallowance represents costs allocated to SWB by its parent, SBC. In the Commission's opinion the proposed disallowance is unjustified and should not be effected.

SBC was created at the time of divestiture to be a cost center for recovery of various costs from the operating subsidiaries, of which SWB is the largest. Some costs are directly charged by SBC to the operating subsidiary requesting a service or for which the service is performed. Other costs are retained by SBC as admitted holding company costs. Neither of these categories is at issue and no adjustment is proposed. The Staff proposes to disallow approximately $4,640,000 of allocated costs for services provided to all of the operating subsidiaries. Some of those services are provided by SBC personnel, others are performed by outside contractors, and a portion of the services are performed for the corporation by the subsidiaries themselves and billed to the parent. The parent in turn charges the subsidiary for its allocated share of the billing to the parent.

The Staff proposes to disallow all of the allocated costs, contending that those costs are incurred at the choice of SWB and are necessitated by the fact that the parent chooses to do business as a holding company. There has been no study of the correctness of the allocation method or the reasonableness of any of the involved charges. The Staff has not been able to establish any of the allocated costs which would not be incurred if SWB operated on a stand-alone basis.

The Staff's proposed disallowance appears to be based primarily on the fact that the costs at issue are allocated. Since the involved services need to be performed regardless of the corporate structure, the proposed disallowance is unreasonable. An example of those charges involves the relation with shareholders. All of the stock in SWB is owned by SBC whose stock is in turn publically traded. The parent performs the interface with the shareholders. This service would be required by SWB if it were a stand-alone publically traded corporation. The vast majority of the other services at issue are of a similar nature.

T. One Bell Center

In 1979 SWB hired Hellmuth, Obata and Kassabaum Inc. (HOK) to perform a feasibility study to determine whether it would be more economical to construct a new office building or to continue to lease space in downtown St. Louis. At that time SWB owned office space at 100 North Tucker and 1010 Pine and also rented additional space at other locations.

Based upon the HOK study and its own analysis, SWB built the current office building known as One Bell Center (OBC). The HOK study showed that OBC would be more economical than continuing to lease. The analysis indicated a cost savings of OBC over leasing of $12.6 million in 1987. Part of the analysis showing that OBC was more economical was a study concerning the lost efficiency and work time for employees who had to travel between buildings for meetings and to perform their work.

Staff and PC reviewed the HOK study and SWB analysis. Based upon that review Staff witness Meyer and PC witness Riley proposed reductions in SWB revenue requirement based upon their separate determinations that continuing to lease would have been the more economical alternative for SWB. Both Meyer and Riley challenge the basis of the HOK study which compares leasing with construction of OBC. Meyer challenges, specifically, the efficiency study for lost work time due to travel between buildings. Meyer removed the savings associated with the efficiency in his comparison of the costs of leasing versus OBC. Meyer removed the efficiency savings because SWB did not make a corresponding adjustment to its work force and office space which Meyer testified should have occurred due to the increased efficiency. Under Meyer's analysis, when the efficiency savings are removed the resulting costs indicate leasing would have been more economical than construction of OBC. Meyer recommends the Commission adjust SWB's rate base by treating OBC as if it had not been built and then allowing a reasonable amount for leasing costs. Meyer's calculations are made using 155 square feet of office space per employee.

Riley recommended the Commission make an adjustment to SWB revenue requirement to remove the costs of OBC and to allow a reasonable amount for leasing costs. Riley's recommendation as to the reasonable amount of leasing costs is based upon 155 square feet of office space per employee.

SWB opposes any adjustment for OBC. SWB witness Browne testified that it is inappropriate to remove the inefficiency costs in the HOK study without performing a new study. Browne testified that SWB did not reduce its work force to compensate for the increased efficiency of constructing OBC but that the rate of growth was reduced from 14 percent to 3.5 percent due to the increased efficiency. Browne also testified that Meyer and Riley did not interpret the HOK study correctly and that the floor space requirements for SWB are 200 square feet per employee plus additional space for other than office space.

The Commission has considered this issue and has determined that although Meyer may be right that a reduction in work force and office space should have been made in comparing construction of OBC with leasing, the Commission cannot accept the efficiency reduction as the proper determination of the costs associated with any work force reduction. The evidence, of reduced growth and that it is inappropriate to simply remove the amount related to efficiency from the study, weighs against Meyer's proposal. The Commission has determined that there is no question that the efficiency occurred and there is no competent evidence from which to make an adjustment to the savings.

The Commission has also determined that the evidence does not establish with sufficient clarity how an adjustment could be based upon treating OBC as if it had not been built and then establishing a reasonable amount for leasing expense. Office space was at a premium in St. Louis when OBC was constructed and if SWB had not built OBC, there is no way to reasonably determine what space it would now occupy or at what cost. In addition, Meyer and Riley seem to have taken a very conservative view of how much space is necessary for SWB employees and where and at what cost rental space would be available.

The Commission considered PC's proposal to disallow certain of OBC costs based upon whether OBC is used and useful. PC's reduction, though, is calculated on how many SWB employees could be placed in other locations owned by SWB and then determine the unused portion of OBC. The Commission, as stated above, has found that PC's calculations concerning how much office space is needed by SWB are not realistic or supported by the evidence. Also, the Commission finds that the space used by Riley in his analysis may not even be available based upon the evidence presented by SWB. Based upon the evidence, the Commission has determined that there should be no adjustment to SWB's revenue requirement because of the construction of OBC.

U. Advertising

This issue involves a proposal by the Public Counsel to reduce SWB's test year expenses by approximately $2,989,000 representing improper or unjustified advertising costs. The Commission Staff proposes a disallowance of approximately $4,168,000 representing approximately 88 percent of SWB's advertising budget.

Both of the disallowances are generally based on the Commission's standard for advertising stated in RE: Kansas City Power & Light Company 28 Mo. P.S.C. (N.S.) 228 (1986) and RE: Union Electric Company 29 Mo. P.S.C. (N.S.) 305 (1987). Using that standard, all advertising is placed in five categories. The categories of general and safety advertising, generally allowed, are not at issue here and will not be discussed further. Political advertising, although generally disallowed, is not at issue here and will also not be discussed further. The proposed disallowances involve the categories of promotional advertising and institutional advertising.

In Union Electric, supra, the Commission defines promotional advertising as "advertising to encourage or promote the use of electricity". We have generally held that the cost of promotional ads are includable only to the extent that the utility can provide a cost justification for the ads. Institutional advertising is described as "advertising used to improve the company's public image". The Commission Staff concedes that it has not offered the Commission any alternative to the application of the standards announced in the Kansas City Power & Light and Union Electric cases. PC's adjustment is founded essentially on the same principles as that of the Staff. SWB contends the application of this rigid standard to a telephone company rendering service on a statewide basis, and in a competitive environment, is inappropriate. The initial question for determination is, therefore, whether or not the application of the Kansas City Power & Light and Union Electric standard is appropriate for Southwestern Bell Telephone Company. In the Commission's opinion such an application is not appropriate and the proposed adjustments must be rejected.

In spite of the fact that this Commission has, in the last two litigated Southwestern Bell Telephone Company cases, acknowledged that competition is a factor to be considered in advertising expense, the Staff and PC propose to apply the standard previously adopted for electric companies. There are significant differences. An electric company sells only one product. Telephone companies, however, sell a multitude of services and products and are subject to increasingly competitive pressures since divestiture.

Staff and PC have attempted to apply a standard which appears virtually impossible for SWB to achieve. Generally, ads have been rejected in the absence of documentation that additional revenues were generated during the test year in excess of the cost of the test year advertising. SWB handles its advertising through an advertising agency. Not only can SWB not establish the price of individual ads, but it is also impossible to establish the cost of particular ad campaigns. SWB witnesses also described the virtual impossibility of ascertaining whether subscription to a new service or purchase of a new product is in response to a particular ad, contact with SWB personnel, or influence of other satisfied customers. Staff witnesses concede that it is not possible to establish revenue to expense ratios for individual ads or even for campaigns.

Another flaw in the direct expense to revenue ratio is revealed by the proposed disallowance of direct mail expenses even though that advertising provided a method of tracking customer responses. The proposal of the Staff includes disallowance of direct mail expenses which may generate revenues for several years because the revenues in the test year did not exceed the cost. That requirement does not take into account that present revenues are being produced by prior years' advertising costs.

Another fallacy in the rigid application of the electric company's standard is illustrated by SWB's experience with its PLEXAR. PLEXAR is a sophisticated piece of central office equipment which provides service similar to a PBX. The PC proposed disallowance includes approximately $1 million in PLEXAR advertising even though the advertising campaign did not commence until October 1987 and approximately three months is required for a PLEXAR installation. Under those circumstances it was probably impossible for SWB to generate any test year PLEXAR revenues by the advertising in the same year. The PC's witness was unaware of whether or not PLEXAR is a competitive service.

The evidence also develops SWB's nearly impossible burden of meeting the test if it experienced declining market shares as a result of competition. It is conceivable that SWB could be required to advertise heavily merely to maintain the existing market share.

In the Commission's opinion the proposed disallowance is also flawed because of a high percentage of mischaracterization of the nature of the ads. An example is the proposal to disallow approximately $273,000 of advertising for the promotion of calling home at Christmastime. The ad was erroneously characterized as institutional in nature because it enhanced the image of SWB; however, it was actually promotional.

SWB has conceded approximately $386,000 of intrastate allocated corporate advertising but protests the proposed disallowance, which is approximately ten times as great as any similar disallowance in any prior Bell Telephone SWB case. On the evidence presented, the Commission must reject the proposed adjustment.

Post-divestiture operations of a statewide telephone company require a more complicated standard for advertising costs than announced in the Union Electric and Kansas City & Light Company cases. A rejection of the adjustment should not be accepted by SWB as a signal that we intend to accept any advertising expense simply because SWB incurred it. Some documentation of advertising benefit must be developed; however, the Commission is sympathetic with SWB's contention that it must be announced before the fact. The proposed standard, in effect, makes SWB the guarantor of the success of its advertising program on a hindsight basis. The Commission will continue to attempt to develop appropriate standards for advertising expenses for the increasingly competitive telecommunications industry.

V. Operator Takeback/Technician Access Network

1. Operator Takeback

The Staff's proposed disallowance represents annual savings in the approximate amount of $4,317,000 which will result from SWB's reacquisition of telephone operators as SWB employees. Presently SWB makes payments to AT&T for sharing long distance operators and other facilities under a Shared Network Facilities Agreement. SWB is under a requirement to terminate the agreement by the end of 1991 and commenced the operator takeback program in 1987.

The test year of 1987 included both the costs of reacquiring the operators and a full year of expenses under the shared network facilities agreement. The record establishes that by approximately June, 1989, savings effected by the operator takeback program will have offset the implementation costs and future savings will go to the shareholders.

Since the costs of the Shared Network Facilities Agreement and expenses associated with the operator takeback program will not be duplicated during the period of time the rates to be set by this case will be in effect, the Commission is of the opinion that it is reasonable to exclude the overlapping expenses from SWB's cost of service. Contrary to SWB's contention, the disallowance does not amount to a denial of the expenses or initial outlay of the project as the rates in this case are not being set for 1987. Since the expenses will not be duplicated in the future they should not be allowed for the future.

2. Technician Access Network (TAN)

TAN is a program which allows SWB's field technicians to perform maintenance through the use of hand-held terminals. As in the case of the expenses of operator takeback, the test year of 1987 included substantial expenses and investment resulting from TAN's creation. Also like operator takeback, by the time the rates to be set by this case go into effect, the savings resulting from TAN will have recovered the implementation costs.

SWB contends that these specific projects are not the real issue. Instead, it is SWB's position that the start-up costs of any project should not be denied because new projects will continue to be undertaken each and every year.

In the Commission's opinion it is proper to consider those expenditures on a case-by-case basis when the projects occur. The proposed adjustments for both operator takeback and TAN are proper because the extraordinary start-up costs will not reoccur.

W. Yellow Pages

In response to divestiture, SWB decided to reorganize its corporate structure. SWB sought Commission approval of the reorganization, which was docketed as Case No. TM-84-85. As part of the reorganization, SWB proposed to create a separate subsidiary to handle the publication of yellow pages. SWB sought approval of the reorganization by January 1, 1984.

Representatives of SWB and the new publications subsidiary, Staff and PC met with the Commission in an on-the-record conference on December 21, 1983. At the conference SWB representatives expressed their reasons for requesting approval of the separate subsidiary for publishing yellow pages. The subsidiary would be Southwestern Bell Publications, Inc. (SWB-Pub). Under SWB-Pub four additional subsidiaries were proposed to be established. Southwestern Bell Yellow Pages, Inc. (SWB-YP) would sell yellow pages advertising. Ad/Vent Grafx, Inc. (Grafx) would prepare SWB-YP directory material and advertisements and offer their services in the open market. Ad/Vent Information Services, Inc. (AVIS) would offer voice information services and other services in the open market. Southwestern Bell Media, Inc. (SWB-Media) would own all printed products and would obtain all contracts for printing paper, ink, delivery services and foreign warehousing of telephone books for SWB-YP, and attempt to market its services to other customers.

As part of its presentation to the Commission, SWB representatives made certain assurances concerning the operations and profitability of yellow pages operations. First, Royce Caldwell, then Assistant Vice President-Revenues and Public Affairs for SWB, stated that the creation of a separate subsidiary for yellow pages would not prohibit the Commission's authority to impute revenues from yellow pages to SWB. Caldwell's representation is consistent with the ruling by Judge Greene leaving the yellow pages with the Bell Operating Companies so the revenues could be used in setting local exchange rates. US v. AT&T, 552 F. Supp. 131, 193-194 (D.C. D.C. 1982).

James E. Taylor, an attorney representing SWB, stated that the accounting system to be adopted by the publications subsidiaries would make a review of the expenses and revenues easier. Caldwell stated that SWB would work with Staff to ensure Staff understood the accounting procedures to be used and the tracking methods to be used. Al Parsons, then Vice President-Directory of SWB and President Designate of SWB-Pub, stated that SWB studies showed a steady rise in revenues from yellow pages for the five years after January 1, 1984, and a decreasing expense component during the same period. Parsons stated the reorganization was proposed to maximize the contribution of yellow pages.

Based upon the representations of the SWB representatives, the Commission approved the reorganization of SWB which separated yellow pages operations from SWB operations. Where, before, yellow pages expenses and revenues were on the books of SWB, now these expenses and records are kept by the subsidiaries. Since yellow pages expenses and revenues are no longer maintained on SWB books, the Commission must impute yellow pages' net income before taxes to SWB. This is known as the contribution of yellow pages to SWB.

1985 was the first full year of operation for SWB-YP after the changing of accounting systems. 1985 also marked the high point in SWB-YP contribution to SWB. The contribution decreased significantly from 1985 to 1987, the test year in this case.

Problems occurred within SWB-YP which contributed to the decline in contribution, and problems occurred in the marketing of the services offered by the other subsidiaries which had an effect on SWB-YP's operations. First, SWB-YP experienced difficulties with uncollectibles in late 1985 which continued in 1986 and 1987. SWB-YP wrote off a number of bad debts in 1986 and 1987 which would cause a decrease in the contribution level. To correct this problem with uncollectibles, SWB-YP implemented new credit policies. In addition, certain one-time adjustments occurred in 1987 which affected the contribution level for that year. These problems make the 1987 contribution level unrepresentative for determination of the proper contribution level for SWB-YP.

Reorganizations within the subsidiaries under SWB-Pub affected SWB-YP. Grafx was dissolved in 1986 with its functions and some of its employees going to SWB-YP. Also, in January 1987 employees from SWB-Media were transferred to SWB-YP. In 1988 several AVIS employees were transferred to SWB-YP.

The brief history of SWB-YP operations and those of its sister companies have not lived up to the representations made by SWB representatives in support of authorizing the creation of the subsidiaries. Revenues have not been maximized; contribution levels have not remained level, but dropped dramatically in 1986 and 1987. This decrease in contribution is attributable to many factors which occurred in 1986 and 1987. Problems with uncollectible revenues and shifting of employees to SWB-YP as sister subsidiaries failed to perform as expected, are two of the factors. SWB cites additional factors such as SWB-YP's inability to increase rates, the need to tighten credit, the development of better means to record true direct and indirect expenses, and competition.

The evidence indicates that the 1988 contribution level will increase over 1986 and 1987 because of procedures implemented to correct for the problems incurred. SWB would have the Commission set rates in this case based upon the 1987 contribution level, which SWB admits is affected by the problems set out above. SWB proposes, as an alternative, the Commission true up SWB-YP by using 1988 expenses and revenues.

The Commission has determined neither of the alternatives proposed by SWB is reasonable. SWB would have the ratepayers absorb the loss in contribution which occurred because of the problems discussed above. The Commission has determined that SWB should be held to its representations that creation of SWB-YP would not harm ratepayers. The problems which occurred are all within SWB-YP management's control except competition. The evidence indicates these problems manifested themselves in the revenues in 1986 and 1987 and corrections have been made which have resulted in increased revenues in 1988. The Commission has determined that the 1985 contribution level, with one adjustment, should be maintained until SWB-YP or SWB can prove that the reduction in contribution is not the result of problems controllable by management.

The one factor cited which is not under management's control is competition. The evidence, though, indicates that competition for SWB-YP is not significant and SWB-YP's major competitor in Kansas City has quit the market. The Commission finds this factor is not significant enough to adopt a lower contribution than 1985's.

The one adjustment the Commission has determined should be made to 1985 revenues is to reduce the 1985 net revenue by $5.9 million. SWB witness Roesslein testified that when SWB-YP increased its reserve for uncollectibles in 1986 by $93.2 million, it had the effect of reducing SWB-YP revenues in Missouri by $5.9 million for 1985. The Commission has determined it is reasonable to make this adjustment to Staff's 1985 contribution level.

The Commission has also determined that to be consistent, the 1985 prepayment balance should also be adopted. This will keep all yellow pages costs and revenues at the 1985 level until it is proven another year is more appropriate.

Staff has asked the Commission to order a continuing investigation into SWB-YP because of the relationship between SWB-YP contributions and rates set for SWB. Staff also requests the Commission order SWB to work with Staff in developing procedures for more timely responses to DRs by SWB-YP and for SWB-YP to maintain state-specific records.

The Commission, based upon SWB representations at the on-the-record conference, expected that SWB-YP records would be accessible to Staff. It would seem that SWB would also want access to SWB-YP records to ensure the proper contribution is being made. The problem arises in devising a solution to this problem. For the Commission to order establishment of a regulatory affairs group within SWB-YP may be beyond the Commission's authority. The Commission could authorize a continuing investigation by Staff, but this would create a continuing and probably confrontational relationship which would expend Staff resources without a rate case focus.

The Commission has determined that a more appropriate alternative is to place the choice on SWB-YP. The Commission will continue to use the 1985 contribution level in setting SWB's rates until SWB or SWB-YP can prove that level is not appropriate. That proof must be in the form of state-specific information made accessible for a Staff audit.

Staff presented evidence and raised the issue of a contract between SWB and Custom Printing Company of Owensville, Missouri. That issue will be addressed in the Affiliated Transactions section.

X. Capital Deployment

Between 1983 and 1987 SWB replaced twenty-five (25) electromechanical central office switches with digital switches. The replacements were a continuation of a replacement program into the outstate areas served by SWB. To determine what offices should be changed out, SWB used its Capital Utilization Criteria (CUCRIT) model to analyze whether the replacement was economically justified. SWB also reviewed uneconomic factors such as market requirements and regulatory requirements in deciding which central office switches to replace.

The switches replaced by SWB were electromechanical switches, Step by Step, and Crossbar. Step by Step switches were first installed in the early 1900s, while Crossbar switches were installed beginning in 1950. These switches have been upgraded and expanded as required with newer equipment, so the average switch age would be less than the location life of the switch.

The digital switches are a more sophisticated technology than the electromechanical switches. With the digital switches a greater variety of services can be offered to customers. Digital switches are also needed to provide equal access, 1+ dialing, to interexchange carriers (IXCs).

In conducting its audit of SWB operations in this case Staff reviewed the justifications and analyses used by SWB in making the switch replacements. Staff reviewed nine of the switch replacements in detail and 16 in an overview. To conduct its analysis, Staff contracted with an outside consultant, James Goggan of Telcom Appraisal. The nine central office switch replacements studied in detail by Goggan are: Fisk, Qulin, Puxico, Puxico West, Poplar Bluff, Willow, Nixa, Sappington and Moberly.

Goggan reviewed SWB's support for the switch replacements and concluded that even though market and regulatory requirements might influence decisions, the final decision to replace switches should turn on whether the replacement is economic. Goggan's focus was on the planning tools used by SWB, especially CUCRIT. SWB's analysis using CUCRIT indicated the switch replacement would be economic. Goggan analyzed CUCRIT data and determined that it was not accurate and needed to be adjusted in ten areas. With these ten adjustments, Goggan's analysis showed that the replacements were not economic. Goggan attempted to view the planning process as performed by SWB at the time of its initial studies without using the hindsight of the actual costs which became available.

The ten areas which required adjustment based upon Goggan's analysis were:

(1) training costs for new technology;

(2) pricing of unused electromechanical switching material;

(3) planning period;

(4) maintenance expense;

(5) digital maintenance material costs;

(6) software right-to-use fees;

(7) capital cost overruns;

(8) employee movement training;

(9) growth forecasting;

(10) switching control center costs.

In his surrebuttal testimony Goggan states that the dominant factors in determining whether the replacements were economic are the cost of digital equipment versus the present worth of maintenance personnel costs saved. Although Goggan could not utilize his data in CUCRIT, he testified his manual analysis pointed up problems with the CUCRIT analysis. Goggan was also critical that SWB did not have the proper tracking and feedback procedures in place so CUCRIT data could be updated and improved to assure problems were corrected and future decisions were based upon the most current data.

A review of the evidence indicates that in several areas Goggan's analysis shows that SWB's planning was not as comprehensive as it should have been. SWB has recognized and corrected a major problem by creating a Capital Tracking Group (CTG) to review its replacement program. This group did not become fully staffed until 1988. SWB has also been performing restudies of the offices reviewed by Goggan. These restudies show that the economic benefits from the replacement are not as great as projected in the original study. According to the restudies, though, each of the new central offices reviewed in detail by Goggan is still economic.

Both SWB witnesses and Goggan have made detailed analyses of the planning process and support for the switch replacements. SWB has criticized Goggan for attempting a prudency review rather than an economic review. SWB attempts to discredit Goggan's analysis because Goggan attempted to focus on the original planning process rather than using the actual data available to determine if the replacements were economic.

The Commission finds this argument rather self-serving. If SWB had filed a general rate increase case to recover the costs associated with its replacement programs, it would have accused Staff of improperly using hindsight if Staff had performed a review as suggested by SWB. The Commission believes both methods have validity as regulatory tools and should be used in determining whether capital expenditures should be recovered through rates. In this case, Goggan has demonstrated that SWB's planning process was in some ways deficient. This has been confirmed by SWB restudies. With the increased knowledge obtained by SWB through its CTG, it should be able to make better decisions concerning which offices to replace.

Even though the Commission has found that SWB's economic benefit analysis was deficient in some aspects, the Commission agrees that there are other factors which must be weighed in deciding when and where to replace central office switches. SWB must be aware of its service obligations, the overall quality of service provided by its existing equipment, the requirements of regulatory agencies, and its own resources.

When SWB began the planning process for replacing the 25 switches it replaced from 1983 through 1987, SWB was winding up its modernization of its metropolitan areas. Decisions needed to be made whether digital switching was necessary and economic for the more rural areas of SWB's service territory. There is no question that digital switches would allow SWB to offer additional services to the affected customers. SWB was also obligated to provide equal access to IXCs and digital was the best means of providing that access.

The Willow and Sappington switches were replaced because they were subject to equal access requirements. Even though the evidence indicates SWB may have made its decision to change out the switches before it was legally obligated to do so, the replacements would have had to be made at some time.

The Commission believes that equal access is in the public interest and that SWB was reasonable in interpreting the need to replace the Willow and Sappington switches. Evidence was adduced concerning adjunct technology which SWB could have used. The Commission finds that there is a question as to the reliability of adjunct technology and it was more reasonable in this instance to replace the switches than use an adjunct.

The evidence concerning whether the replacement of switches by SWB was economic is mixed. SWB's original studies showed that the Belton and Liberty switch replacement would be uneconomic. Goggan's review pointed up other problems with CUCRIT and SWB's restudies reduced the benefit by 36 percent for the replacements.

The Commission, though, must weigh SWB's overall planning process as well as the economics of the individual switch replacements. The electromechanical technology is a mature technology which has served SWB well, but which even Goggan admits should be replaced where economic. SWB had an opportunity in these times of reduced inflation, lower costs and TRA changes to replace switches without seeking a rate increase. The evidence is that SWB can continue this program even with the revenue reduction approved in this case. The Commission has determined that it was reasonable to make the replacements at this time even though the replacements might not all have been required by regulatory agencies or could be shown to be economic.

Staff's adjustment would penalize management for recognizing an opportunity and the availability of revenues to make capital improvements without a rate increase. The Commission has determined such a penalty would be unreasonable in these circumstances. Whether the evidence in this case would have supported inclusion of all of the replacements in a rate increase case is another question. Other LECs who might seek to modernize must evaluate their own needs and resources. The Commission understands that there may be some risk to the new digital technology, both with the equipment and with potential obsolescence. The evidence in this case is that digital will be in place for over 15 years and probably in the more rural areas for even longer. The installation of the digital switches may allow SWB to delay installing new technologies or even to "leapfrog" new technology. In addition, the Commission believes that the additional services which will be available to the affected exchanges will be beneficial to the public. There are factors other than economics, such as expanded service to customers, improved quality of service and attraction of new customers, which must be weighed in determining whether new technology should be deployed. In this instance, the other factors outweigh any showing of uneconomic deployment.

1. Depreciation/Amortization

Historically, depreciation rates for SWB have been established at the three-way presubscription meetings. These meetings were held each year and included representatives from SWB, the Missouri Commission and other state commission staffs and the FCC. Rates would be agreed upon and presented to the separate commissions for approval. In Missouri the new rate would either be approved by a separate Depreciation Authority Order or as part of an SWB general rate case.

The three-way meetings were significant prior to 1986 because the FCC had determined it could preempt state authority and could set depreciation rates for dual jurisdiction property. In 1986 the U.S. Supreme Court held that the FCC could not preempt state authority over depreciation rates. Louisiana v. PSC, 106 S. Ct. 1890 (1986). Also, Staff witness Richey testified that states in which SWB provides service have not participated as fully in the three-way process in recent years. The last three-way meeting was held in 1986 and the next three-way meeting is scheduled for this year, 1989.

The Commission in Case No. TO-82-3 permitted SWB to utilize straight line remaining life (SLRL) and straight line equal life group (SLELG) depreciation methods. Annual updates are required to be performed as part of the SLRL and SLELG methods. The annual updates would use the same projected lives, curve lines and future net salvages established in the previous three-way meetings and a new remaining life would be determined by performing new generation arrangement calculations. Using the current end-of-year book depreciation reserve, revised average depreciation accrual rates would be calculated. New parameters would be established at each three-way meeting. The FCC made the annual updates optional and this Commission has not addressed the issue.

In this case Staff has updated SWB's depreciation rates to reflect a 1987 annual update. Staff calculated new remaining lives for all accounts except Central Office Equipment (COE)-Step by Step, COE-Crossbar, and COE-Operator Systems. These accounts were not adjusted based upon Staff's proposed adjustment in the Capital Deployment issue. Staff proposes the new rates in conjunction with the ending of the amortization of the depreciation reserve deficiency authorized in Case No. AO-87-48.

As a result of an agreement reached during the 1986 three-way meeting the depreciation rates for SWB for interstate and intrastate accounts are the same except for COE-Step by Step. These rates were approved for SWB in the Stipulation And Agreement in Case No. TR-86-84. The new depreciation rates took effect January 1, 1987. The Commission approved Staff's depreciation rates for COE-Step by Step in TR-86-84.

The 1986 depreciation rates were modified by a Stipulation And Agreement in Case No. AO-87-48. In AO-87-48 the parties agreed that SWB would book intrastate depreciation consistent with the interstate depreciation rate levels filed by SWB with the FCC on July 24, 1987. These rates included amortization of a reserve deficiency found to exist by the FCC and the associated technical update of all rates.

The Stipulation And Agreement in AO-87-48 stated that no party, including Staff, was bound by the agreement in any future rate proceeding. The agreement was reached in AO-87-48 as part of an agreement by SWB to give residential customers a credit for changes in the tax law and because of the two-year moratorium on rate changes agreed to in Case No. TR-86-84.

Staff is recommending its depreciation rates be established and made effective the same time as the Report And Order in this case. This would leave approximately six months for the depreciation rates to be in effect until new depreciation rates are set in the three-way meeting held this year. SWB recommends that the existing rates be maintained and new depreciation rates set at the three-way meeting. If interstate and intrastate rates are the same, it will reduce administrative costs for SWB. Currently the other states in which SWB operates have different intrastate depreciation rates and SWB must maintain separate accounts for those states. The Commission believes the three-way process should be utilized to attempt to reach agreement between interstate and intrastate rates. Where the parties cannot agree the Commission can then determine the appropriate depreciation rates for those accounts when there is no agreement.

In this case the Commission has determined that it is reasonable to adopt the 1987 technical update depreciation rates. This is the annual update required by the SLRL method. Even though the three-way meeting will establish new projected lives, curve shapes and future net salvages, they will not go into effect until January 1, 1990, and then only if there is agreement. The Commission has determined it is more appropriate to update the depreciation rates, especially since the Commission will be ending the amortization of the theoretical reserve deficiency.

The Commission has determined that the methods adopted in TO-82-3 are still the proper methods for setting depreciation rates. SLRL and SLELG, when used with annual updates, will allow full recovery of capital costs. SWB filed a technical update in 1987 with the FCC when it decided it was needed, but rejects the concept when Staff proposes it. The Commission finds that annual technical updates will provide recovery of SWB's capital costs. The Commission will utilize the depreciation rates set by Staff in the 1987 technical update. Staff shall also calculate new remaining service lives for COE-Step by Step and COE-Crossbar because of the Commission's decision on the Capital Deployment issue.

The Commission accepts Staff's position that the amortization of the FCC-accepted reserve deficiency be ended. The Commission has determined the SLRL and SLELG depreciation methods, when annually updated, will provide recovery of any reserve imbalance which has occurred. This method will also avoid the fluctuations in the reserve deficiency which are caused by changes in average remaining lives and average service lives which occur at each three-way meeting.

SWB witnesses testified that there is only a five year window of opportunity for SWB to recover the reserve deficiency or it will lose business because of its interLATA access and intraLATA services which are subject to competition. The Commission is not convinced by the evidence that the window of opportunity is as narrow as SWB witnesses testified. The Commission, though, has determined any amortization which would be required to meet the closing window should be done on a sharing basis between shareholders and ratepayers. The Commission has determined that the SLRL and SLELG depreciation methods with annual updates will provide recovery. If SWB wishes to have accelerated recovery through amortization, the Commission would expect the amortization of the reserve deficiency to be shared between shareholders and ratepayers. This sharing would allow SWB to meet its concerns about increased competition while not placing the burden for the recovery of accelerated depreciation entirely on customers.

By accepting the sharing option SWB would agree to continue the amortization of the reserve deficiency during the remainder of the five-year period, while only recovering $5.804 million annually in revenue for the amortization. The depreciation rates prescribed by the Commission, if SWB accepts the option, would be updated rates provided by Staff witness Richey on June 2, 1989. These depreciation rates are attached to this order as Attachment A. SWB may, at its option, request recovery of any remaining portion of the reserve deficiency expense in rates in a future proceeding during the remainder of the five-year amortization period.

SWB shall inform the Commission by June 22, 1989, whether it will accept the option as discussed above.

DOD witness Prisco has proposed a compromise for treatment of any depreciation reserve deficiency. The compromise would amortize any depreciation reserve deficiency over a four-year period with the removal of the unamortized portion from rate base. This compromise would be another method available for the sharing between shareholders and ratepayers of any reserve deficiency.

Y. Rate of Return

The determination of the appropriate rate of return (ROR) in this case involves decisions concerning the appropriate capital structure and the appropriate return on equity (ROE). As in other cases, the parties to this case have presented the Commission with a substantial amount of testimony and evidence concerning the proper methods to be employed in determining a rate of return, as well as a substantial amount of evidence as to the appropriate factors to utilize in each method.

There is usually some agreement among the parties concerning the appropriate capital structure to be utilized and the evidence focuses on the required ROE. Here, though, Staff, Public Counsel and DOD have proposed the Commission adopt a hypothetical capital structure for SWB. SWB has proposed that its capital structure as of December 31, 1987, be used.

1. Return on Equity

Six witnesses testified concerning the ROE for SWB. Each witness presented evidence supporting his or her own calculations and pointed out purported inconsistencies or inaccuracies in opposing witnesses' testimony. The differences in the proposed ROEs are set out below:

Shackelford	12.61 - 13.32 percent
Ileo	10.99 - 12.67 percent
Winter	11.11 - 11.23 percent
Fox	14.7 - 15.3 percent
Pettway	14.5 - 15.5 percent
Avera	14.5 - 15.5 percent

Staff's proposal for the appropriate ROE for SWB in this case was developed in a two-step process. In its first step, Staff witness Shackelford developed a ROE for SBC, the parent corporation. In the second step, Public Counsel and Staff joint witness Ileo calculated a ROE for SWB by calculating DCF analyses of companies comparable to the unregulated subsidiaries of SBC, and then calculated SWB's ROE residually utilizing Dr. Ileo's hypothetical capital structure and Shackelford's ROE for SBC.

A direct company DCF analysis cannot be performed on SWB because it is not publicly traded. SBC holds all of the equity of SWB. The determination of SWB's ROE must be made, then, based upon either the ROE of the parent company or comparable telephone companies. Ileo testified that in his opinion there were no telephone companies comparable to SWB. SWB witnesses contend that SBC is a suitable proxy for SWB and a ROE developed for SBC should be reasonable for SWB. SWB witnesses, of course, disagree with Shackelford about what the appropriate ROE for SBC is.

The regulated telephone operations of SWB comprise 87-89 percent of the parent corporation's assets and almost 96 percent of SBC's before-tax income. When coupled with SBC's Yellow Pages subsidiary, income from regulated telephone operations is over 100 percent of SBC's income. This dominance of SBC's financial statements by SWB is the basis for SWB's argument that SBC is an appropriate proxy for SWB and forms the basis for Ileo's position that debt raised by SBC is supported by SWB earnings.

The evidence concerning the appropriate ROE for SBC involves use of analyses based upon DCF methods, the capital asset pricing model (CAPM), and risk premium calculations. Staff presented a ROE for SBC based upon the constant growth DCF method. Staff's method calculates a ROE by the formula: $K = D_1/P_o + g$. The formula calculates K, the required rate of return, by adding the yield, D_1/P_o, plus the growth, g. To calculate the yield component, Shackelford first determined P_o by taking an average of the market prices of SBC common stock for the three months of March, April and May 1988 and six months of December 1987, January, February, March, April and May 1988. Shackelford testified that although the DCF method uses current price for P_o, fluctuations in SBC stock since January 1987 make current price unrepresentative in his opinion, so he took a range to better reflect investor evaluations. For the D_1 component, Shackelford utilized SBC's indicated dividend per share for each month used in his P_o calculation and calculated an average for the months used, and then divided D_1 by P_o to get a range of yields from 6.82 percent to 6.61 percent. Shackelford updated his yield calculation in his surrebuttal testimony and the results fell within his yield range.

Shackelford utilized analysts' forecasts for arriving at the growth element of the DCF formula. Shackelford testified that historical growth rates were not appropriate because SBC has only four years of data. Four years is too short a time to use to make a growth projection. Shackelford instead used the projections of three investor services. Shackelford calculated a growth rate of 6 percent to 6.5 percent for SBC. In his surrebuttal testimony, Shackelford updated his analysis and the results fell within his range.

SWB witness Fox takes issue with the constant growth DCF model utilized by Shackelford and proposes instead that a multistage dividend discount model is the more appropriate DCF method for determining SBC's ROE. Fox contends that the constant growth model, which assumes that earnings growth, dividend growth and price appreciation all grow at the same rate into perpetuity, is too simple and does not reflect current market expectations or conditions. Fox utilized the multistage model to account for expected growth in price appreciation of SBC common stock to accurately evaluate investor expectations. Fox determined SBC stock would grow at an annual rate of 8.5 percent and she utilized that growth rate in calculating her range of ROE for SBC of 14.7 percent to 15.3 percent.

SWB witnesses Pettway and Avera support Fox's range through analyses based upon CAPM and risk premium calculations. Pettway urges the Commission to adopt the CAPM method for determining rates of return for public utilities, especially SBC and SWB. Pettway characterizes the constant growth method used by Staff witness Shackelford as "naive" and simplistic and Fox contends it is not "robust" enough to meet current market requirements.

DOD witness Winter testified that in his opinion, SBC's current return requirements are within the range of 11.11 percent to 11.23 percent because SBC's risk corresponds to the risk of double-B bonds. Winter used data from Standard and Poor's (S&P's) Bond Guides of October and November 1988 to establish this range. Winter contends that the range of ROEs for SBC proposed by SWB witnesses correspond to required returns for triple-C bonds, which are far riskier than SBC common stock.

Winter also contends that SBC is not an appropriate proxy for SWB and that SBC's ROE should be reduced by at least 20 to 30 basis points to make it applicable to SWB. Winter testified that risk premiums, over long term government bonds, that were available to investors in utility stocks averaged between 166 to 367 basis points. These returns, Winter testifies, are directly related to returns historically available to investors.

As recognized by the parties, the Commission has, in recent years, almost exclusively utilized the constant growth DCF method for determining the ROE for the public utilities under its jurisdiction. Even though characterized as simplistic or naive, the Commission has found that the DCF method takes into account investor expectations, including the risk of a particular common stock. The constant growth DCF method, with adjustments for particular circumstances, has been used to set rates for small water companies as well as electric utilities with nuclear construction. The returns developed using this method and approved by the Commission have been reasonable and have maintained the financial integrity of each utility. The Commission has heard no evidence in this case to justify adopting CAPM or some other method. The Commission has determined that the constant growth method suffers less from the defects that plague all methods, that is, wide swings in results based upon what data is used.

The CAPM method seems to suffer greatly from this failing, as seen by the difference in results using the .70 Merrill Lynch beta for SBC rather than the Value Line beta of .90. There was no evidence that one beta was more accurate than the other. Risk premium analyses are also subject to volatility based upon the data utilized. The basic assumption of the risk premium approach is valid, that the greater the risk the greater the required return, but there is no consensus on how to measure risk and required rates of return from common stock are unobservable. The volatility of risk premium analyses is shown by changing SWB witness Avera's data by utilizing that data presented by Staff witness Shackelford.

The Commission finds that for determining the ROE for SBC, the constant growth DCF method is the most reasonable. CAPM, risk premium and comparisons with comparable companies can provide a check on the reasonableness of the results of the DCF method, but have not been shown to be more reliable or trustworthy merely because they are more complicated or more recently developed.

The Commission finds further that the constant growth method is better suited for determining the ROE for SBC in this case. SWB witness Fox's 8.5 percent growth factor is not reasonable. The Commission finds that investors' expectations concerning telephone company stocks have not changed so dramatically that they require a growth factor other than that provided for in the constant growth model. Telephone utility stocks, such as SBC, which are dominated by regulated subsidiaries are still safe, stable investments which provide constant long term growth and earnings.

The Commission has determined that because of the dominance of SBC's revenues and assets by SWB, SBC is an appropriate proxy for SWB. The Commission would prefer a company-specific DCF, but in this case finds that SBC provides a reasonable substitute. The Commission finds that it is more reasonable to utilize SBC as a proxy than to attempt to find comparable companies to utilize in determining a reasonable ROE for SWB. The Commission has not accepted comparable company analyses in the past because, as in this case, companies are rarely sufficiently comparable. Where an appropriate proxy is available, it is preferred to utilizing comparable companies.

By finding that SBC is an appropriate proxy for SWB, the Commission has determined that the ROE for SWB developed by Staff witness Ileo is not appropriate. The major fault lies in Ileo's determination of a ROE for SWB based residually upon calculation of ROEs for SBC's unregulated subsidiaries. The Commission cannot adopt this approach. Ileo agrees with SWB that the telephone company dominates SBC's assets and income. Ileo would adjust SBC's ROE for this to arrive at a ROE for SWB. The Commission has determined, instead, that SBC should be used as a proxy for SWB. The Commission, though, has determined that Ileo's analysis of the use of SWB to issue debt for SBC indicates it is reasonable to look at the low end of the DCF range proposed by Shackelford in establishing a ROE for SWB. SWB is less risky than the consolidated parent SBC.

The Commission has determined that the low end of Shackelford's range is also indicated by DOD witness Winter's testimony concerning risk premiums. The Commission finds Winter's risk premium evidence of 166 to 367 basis points reasonable and when added to the current rate for long term government bonds resulted in a ROE either below or in the low end of Shackelford's range of 12.61 percent. The current long term government bond rate is the appropriate risk-free rate to use in making this check for reasonableness.

The Commission would also point out that it determined a ROE of 14.7 percent was appropriate for SWB at the time of divestiture, Case No. TR-83-253. This rate was based on then-existing economic conditions and the uncertainties surrounding SWB's future as a stand-alone company. Since January 1984 interest rates have gone down as much as 350 basis points and many of the uncertainties faced by SWB have been removed. The Commission finds it would be unreasonable to now allow SWB a ROE of 14.7 percent or above as proposed by SWB witnesses. The premium between the 14.7 percent ROE approved in TR-83-253 and double-A bonds in 1983 was 1.52 percent to 1.87 percent. That premium is less than that approved in this case. The Commission finds that 12.61 percent is the appropriate ROE for SWB.

SWB has proposed the Commission adjust the ROE found to be reasonable for flotation costs. Since there is no evidence SBC will be issuing common stock in the near future, the Commission has determined an adjustment for flotation costs is inappropriate.

2. Capital Structure

Staff witness Shackelford calculated the cost of capital for SBC on a consolidated basis at December 31, 1987. He also furnished the amount of debt outstanding for SWB at December 31, 1987, to Staff and Public Counsel witness Ileo. Both Ileo and Winter proposed the Commission adopt hypothetical capital structures for SWB. SWB proposed that the actual capital structure as of December 31, 1987, should be utilized in determining the overall rate of return.

To arrive at his hypothetical capital structure, Ileo developed a composite capital structure for six of SBC's unregulated subsidiaries and then subtracted that composite capital structure from the SBC capital structure developed by Shackelford to obtain SWB's capital structure. In determining his hypothetical capital structure, Ileo did not include Southwestern Bell Credit Corporation (SBCC). SBCC had debt of over $1 billion, which Ileo viewed as being financed by SWB since SBC's profitability is dominated by SWB. The result of imputing SBCC's debt to SWB is to change SWB's capital structure from 43.64 percent debt and 56.36 percent equity to 52.95 percent debt and 47.05 percent equity. Ileo distributed SBC's cost of capital to SWB and the six other subsidiaries based upon net assets.

DOD witness Winter recommends a hypothetical capital structure in this proceeding of 50 percent debt and 50 percent equity. Winter contends this hypothetical capital structure would be more efficient than SWB's current capital structure which is consistent with the economical and efficient management of a utility. Even though the higher debt ratio would reduce credit ratings, Winter testified that the costs of maintaining the higher credit rating were not offset by the reduction in capital costs of the higher rating.

The Commission has adopted hypothetical capital structures in the past, especially in situations where the utility is the wholly-owned subsidiary of a holding company. This double leveraging has been approved by Missouri courts. Here, the hypothetical capital structures, though, go beyond double leveraging and are based upon other factors.

The Commission has determined that a hypothetical capital structure as proposed by Winter, based upon single-A credit ratings or with reference to the trade-off of the cost of maintaining a credit rating versus the reduction in capital costs of the higher rating, is not appropriate in this case. The Commission is not convinced that a capital structure developed on that basis is reasonable.

The Commission finds that Ileo's residually determined capital structure for SWB is also not reasonable. The Commission is not convinced that the imputations made by Ileo of the debt associated with the Metromedia purchase is appropriate, nor that they reflect the effect of the purchase of Metromedia on SWB. Following Ileo's method would raise SWB's debt ratio from 43.64 percent to 51.6 percent. This is a significant increase in the debt ratio and could have an adverse effect on SWB's credit rating.

The Commission, though, is persuaded by Ileo that some recognition of the role SWB's financial strength played in SBC's debt should be made. The Commission agrees that it is not logical for SWB to have a lower debt ratio than SBC when SWB is, in fact, less risky than SBC. The Commission has determined that since SBC has been found to be an appropriate proxy for SWB for ROE, its capital structure is also more representative of the appropriate capital structure for SWB. The dominance of SWB of SBC in all aspects reinforces this decision. Since SWB is, in reality, SBC, it should get the benefit of SBC's capital structure, which reflects the debt for Metromedia. The capital structure as provided by Shackelford as of December 31, 1987, is the capital structure which will be utilized for developing the rate of return in this case.

Based upon the above findings the Commission has determined that SWB's capital structure should be 45.37 percent debt and 54.63 percent equity. Taken with the 12.61 percent ROE found to be reasonable, the Commission finds SWB's overall cost of capital is 10.73 percent.

3. Management Efficiency and Economy

Staff has proposed the Commission authorize SWB to earn at the low end of Staff's proposed ROR because of alleged deficiencies in SWB's management practices.

Staff has proposed no discrete adjustments for these management deficiencies. The Commission has determined that it is not appropriate to adjust the rate of return SWB will be authorized to earn for management decisions. Now the Commission has determined that where it has made adjustments to ROE in other cases, these type of adjustments can rarely be supported by sufficient evidence to warrant such a decision. The difficulty of deciding how much value a certain management decision has in terms of ROE makes the determination almost impossible. The evidence in this case provides no real guide to the Commission on how to value the various allegations of inefficient management. The more appropriate method for making adjustments to a public utility's revenue requirement is where specific dollar adjustments can be addressed, not by adjusting the ROE.

Staff sums up its reasoning to support its recommendation that SWB earn the low end of Staff's recommended ROE as SWB "consistently selecting systems or following practices and procedures which favor its shareholders at the expense of its ratepayers and which are neither efficient or economic." Although the Commission does not condone management decisions which focus only on maximizing shareholder returns to the exclusion of rates, the Commission does not believe those types of decisions necessarily indicate an inefficient management. In fact, a company which provides shareholders a continually higher return on their investment might be very efficient. In the regulatory environment, though, maximizing shareholder returns must be weighed against the rates charged customers for service, and management decisions should include a consideration of the effect of the decisions on ratepayers.

The focus of an analysis of management efficiency must be on the procedures and decisions made by a company which provide a quality of service which meets regulatory standards at a just and reasonable price. The measurement of any management efficiency, though, is inexact and subject to subjective criteria. SWB's analysis of its overall management efficiency is based upon net income and customer perception surveys. Staff witness Wimberley testified that SWB's management procedures should follow a management cycle which plans, engages, directs and controls resources in a manner which reasonably assures that the objectives and measurable goals of the company are accomplished efficiently and economically.

Wimberley found SWB's planning process deficient in that it failed to establish price as an objective, used customer perceptions to establish goals rather than technical standards, and used net income as a goal rather than goals related to objectives regarding cost. Wimberley also found deficiencies in SWB's incentives for employees and found that SWB does not have a capital tracking system to verify performance of capital expenditures.

SWB, of course, contends it is being managed efficiently and its measurements show that efficiency. The measurements introduced into evidence by SWB include the Management and Operations Effectiveness Report (MOER) performed by Deloitte, Haskins & Sells (DH&S) in 1987; comparison with other RBOCs; and results of customer perception surveys. The Commission has addressed the value of comparisons with industry averages or other utilities in other decisions. RE: Union Electric Co., 27 Mo. P.S.C. (N.S.) 183, 193 (1985); RE: Kansas City Power & Light Co., 28 Mo. P.S.C. (N.S.) 228, 281 (1986). The Commission finds industry comparisons or averages to be of little value in setting an individual company's revenue requirement. Each company is different and each company must be examined based upon its own costs, revenues and investments. The comparisons used by SWB do not indicate its management efficiency but only its general ranking with other RBOCs, which may or may not operate under similar circumstances. Staff's comparisons with Missouri LECs suffer from the same flaw.

DH&S concluded in its MOER report that SWB was a well-managed organization. Staff criticized the MOER report for failure to include a cost benefit analysis. The evidence concerning the report is not conclusive of either Staff's position or SWB's. Staff failed to take advantage of the opportunities offered by SWB to review the data upon which the report was based and to interview SWB employees interviewed by DH&S. SWB did not include Staff in the initial interviews and did not allow it to fully participate in the management audit. The failure of SWB and Staff to work together in the management audit has reduced the value of the audit. Through cooperation, the audit would have provided guidance to SWB on improvements in its management.

Staff has not quantified any of the deficiencies it found in SWB's management, while SWB has relied upon reduction of customer complaints and improvement in customer perceptions to support its claim of management efficiency. Without quantification the Commission cannot make adjustments to SWB's revenue requirement. In addition, reliance on customers' perceptions to establish management efficiency is at best misplaced. Customer perceptions reflect quality of service and price but do not reflect costs, and they reflect the quality of a company's service but not how efficiently that service is being provided.

It should be pointed out that SWB did recognize its management procedures for tracking and feedback of capital deployment decisions were deficient. SWB established the Capital Tracking Group (CTG) to correct that deficiency. The Commission has addressed the CTG in the section on Capital Deployment. This group should meet some of the criticisms of Staff concerning SWB's failure to properly monitor its capital deployment decisions and thus make corrections to its analysis as new data is evaluated.

The Commission has addressed the incentive plans for employees individually in the Employee Compensation section. The Commission has agreed with Staff that some of these incentives are not reasonable and the costs have not been included in SWB's revenue requirement. SWB's overall compensation plan appears to be geared to customer perceptions rather than cost containment and quality of service. Customer perceptions are an essential part of the evaluation of employees but should not be dispositive of whether incentive payments are earned.

Overall, as with Goggan's analysis of SWB's capital deployment decisions, the Commission has determined Staff's analysis should provide some valuable insight into areas of SWB's management which need improvement. As a substitute for competition, this oversight is essential. SWB's claims of overall efficiency based upon stable local rates are somewhat overshadowed by the rate increase sought in 1986 and the rate reduction ordered in this case. As a regulated company, SWB has an obligation to ratepayers to reduce prices where appropriate as well as to provide quality service.

4. Affiliated Transactions

Staff has proposed that the Commission allow SWB to earn a return on equity at the low end of Staff's proposed range because of deficiencies which Staff found in SWB's procedures for dealing with transactions with affiliates. These deficiencies involve SWB's dealings with other SBC subsidiaries both as a purchaser and as a seller of services. According to Staff evidence SWB offers to sell 43 services, which include 500 pricing elements, to affiliates.

SWB prices the services it sells to affiliates based upon a subjective determination of the price using either external market information, where available, or nonmarket factors. SWB outlined its pricing procedure in the response to Staff DR #305, which can be found in Exhibit 136, Schedule 2. The following factors, among others, are used in setting price when external market information is unavailable: willingness to pay, value of service, appropriate contribution above incremental unit cost, compliance with FCC Docket 86-111 to recover direct and indirect cost, ease with which service can be provided, and whether the service enhances or diminishes another service SWB provides to the affiliate.

SWB indicated that only five of its services are priced based upon external market information: management employment, technical personnel, data processing, mailing, and intraLATA communications. Management employment was later dropped and real estate was added. Staff believes that over 80 percent of SWB's services sold to affiliates should be priced based upon market information and that even for the five indicated by SWB to be market-based, there was not sufficient documentation of market conditions to support SWB's pricing.

Staff is also critical of SWB's procedures for purchasing services from affiliates. Staff examined services provided SWB by Bellcore, SBC Asset Management, Inc. (AMI), SWB-Pub, Southwestern Bell Mobile Systems, Inc. (SWB-Mobile), and Southwestern Bell Telecommunications, Inc. (SWB-Telcom). The Commission has addressed Bellcore in a separate section, where Staff proposed a specific adjustment. The Commission determined that the proposed specific adjustment was not supported by the evidence. Here, Staff criticizes SWB for failing to quantify the benefits from projects undertaken by Bellcore and that SWB's procedures do not require a cost benefit analysis and do not prioritize the projects.

AMI is used by SWB for home relocation and real estate brokerage services. SWB uses SWB-Pub for publication and other services related to SWB directories. SWB-Mobile provides cellular service to SWB, while SWB-Telcom provides voice equipment, personal computers, peripherals and software products.

SWB does not competitively bid for the services it purchases from its affiliates. Staff suggests that competitive bidding would ensure that SWB was receiving the best service for the best price.

Whether SWB is paying prices which are too high for services from its affiliates and charging prices which are too low for services provided to affiliates, generally, is not clear from the record. The Commission has determined it is not reasonable to weigh SWB's purchasing and selling practices in determining the appropriate return on equity. Specific adjustments for specific instances of improper pricing or purchasing are the proper adjustments to be used in establishing SWB's revenue requirement.

The requirement of competitive bidding for services SWB purchases may or may not be cost-effective. Staff's evidence was inconclusive on the criteria to be used for competitive bidding, the costs, and whether competitive bidding is appropriate for all situations. For AMI services the evidence indicated that SWB was paying a lower price than if SWB had stayed with the previous provider, even though SWB did not put out the service for competitive bids. The Commission is not convinced that SWB would have received a lower price from competitive bidding for these services without additional costs offsetting any cost savings.

The evidence, though, does indicate how affiliate transactions can be used to deny SWB the lowest cost provider and thus have ratepayers subsidize affiliates through above-market prices. The evidence indicates that even competitive bidding will not necessarily prevent improper affiliated transactions.

The example presented by Staff is that of a low bid by Custom Printing Company of Owensville, Missouri, to print certain white and yellow page directories. The evidence indicates that Custom Printing was not offered the full contract because of the potential effect on Times Journal Publishing Company, another SBC subsidiary. The contract was awarded to Times Journal. (This evidence is in Exhibit 197HC admitted into evidence in the Miscellaneous section below.) A specific adjustment could be proposed for this transaction if it had occurred in the test year.

The Commission finds that SWB's failure to use market information and to document its pricing criteria makes the prices paid by affiliates to SWB suspect. The fact the prices contain a contribution above incremental cost does not alleviate SWB's responsibility to set a price that will maximize contribution. The admittedly subjective nature of SWB's pricing policy leaves too much discretion for undercharging affiliates. The evidence in this case does not support any specific adjustments for SWB pricing, but the Commission would expect Staff to review SWB's pricing policies in future cases to see if specific adjustments should be made.

MCI raised additional concerns about the potential for cost of service manipulations by SWB and affiliates. MCI witness Cornell testified that cost of service manipulation could occur by having regulated services pay the costs of an affiliate or of a below-the-line service or by designing plant used by both affiliates and regulated services in ways more favorable to the affiliates. Cornell testified that these potential manipulations could occur without a direct transaction between SWB and an affiliate.

MCI supports authorizing the low end of Staff's ROE and urges the Commission initiate a comprehensive investigation into cost of service manipulations for use in future proceedings. The Commission has already determined that it is improper to set a company's ROE based upon affiliated transactions. The Commission finds little merit in the comprehensive investigation proposed by MCI. The evidence does not indicate that MCI's proposal would be productive.

5. 800 Database/CCS7

MCI proposed that SWB earn at the low end of Staff's proposed ROE range because of its expenditures associated with 800 Database and Common Channel Signaling System No. 7 (CCS7). 800 Database is a joint undertaking by SWB and other RBOCs and Bellcore. It is designed to provide equal access for 800 service and allow number portability (a customer with a name recognition 800 number cannot, with the current 800 system, switch carriers since it cannot take the name recognition number with it to the new carrier). The installation of 800 Database would remove this barrier to 800 service competition.

SWB has made capital expenditures associated with 800 Database, but these expenditures were stopped in early 1988. IXCs had challenged, both in court and at the FCC, the development and installation of 800 Database as overly complicated and expensive and could involve the RBOCs, including SWB, in prohibited interLATA activities. 800 Database has not provided service to Missouri customers.

CCS7 is a national and international standard for signaling which allows the telecommunications network to communicate through data links to determine the type of network intelligence needed to process a call. CCS7 is necessary for installation of the 800 Database system but is also used for credit card verification for credit card telephone calls and would allow SWB to discontinue use of AT&T's system.

CCS7 has been deployed to the tandem level in Missouri but expenditures have not been authorized to the end-office level. The system is not fully deployed until it is deployed in the end offices. CCS7 was not in service in Missouri during the test year, 1987.

The evidence is that expenditures for 800 Database and CCS7 are accounted for in SWB's Account 100.2, plant under construction. Since these expenditures are recognized in plant under construction, they are not reflected in SWB's revenue requirement in this case. The Commission has already determined that adjustment to SWB's ROE for management decisions or imprudent expenses is inappropriate. Specific dollar adjustments can be made if expenditures are found not to be reasonable or are associated with plant not used and useful.

When and if SWB deploys 800 Database and CCS7 in Missouri and seeks a rate increase associated with these expenditures, SWB will have to support the reasonableness of these costs. The Commission has determined ordering restudies or other continuing investigations is premature and not warranted under these circumstances.

6. Ten Percent Election ITC

SWB elected 10 percent ITCs instead of 8 percent ITCs. Staff cites this election to support its position that SWB should be allowed to earn at the low end of Staff's ROE range.

The Commission has determined management decisions of SWB do not support a finding that SWB earn at the low end of Staff's recommended ROE range. The decision by SWB to adopt 10 percent ITCs will not be used to support such a finding.

Z. Miscellaneous

1. Staff Motion to Strike Portions of SWB Initial Revenue Requirement Brief

On March 6, 1989, Staff filed a motion to strike certain portions of SWB's initial revenue requirement brief. SWB filed its response on March 10, 1989. The Commission had allowed Staff to file a motion to strike rather than make its arguments in its brief due to the page limitation on the initial brief. Upon reconsideration, the Commission has determined it is more appropriate for a party to make its arguments concerning misstatements or inaccuracies in another party's brief in the reply brief. Only under limited circumstances would a motion to strike a portion of a brief be appropriate. Staff's motion is denied.

The Commission has noted the portions of SWB's brief which Staff has moved to strike and has considered Staff's motion in reviewing the evidence. The Commission believes that one part of Staff's motion needs to be addressed. That is, where an attorney cites his own questions as fact. Facts are only adduced from a witness. An attorney's questions do not establish facts and should not be cited as facts in parties' briefs.

2. Exhibit 111

The transcript fails to reflect that Exhibit 111 was received into the record. The Hearing Examiner's records indicate Exhibit 111 was received. The Commission will admit the exhibit in this order in conformance with the Hearing Examiner's records.

3. Exhibit 197HC

Staff offered into evidence as Exhibit 197HC the response to DR #1484 which contained the decision to award the contract on which Custom Printing had bid. SWB objected to the exhibit since it was offered two days after the Yellow Pages issue was tried. SWB contends Staff could have asked SWB witness Kaufman about the awarding of the contract during the Yellow Pages issue. Staff contends it did not ask about the award of the contract since it was unaware the contract had been awarded until it received the response to DR #1484.

The Commission will receive Exhibit 197HC into evidence. SWB had knowledge of the award of the contract on January 18, 1989, prior to the trying of the Yellow Pages issue. SWB chose to withhold that information until January 31, 1989, until after the Yellow Pages issue was tried. To allow SWB to withhold information until after the issue was heard, knowing it would not be received, would reward SWB for not disclosing information. This would set a bad precedent.

This question is similar to one which occurred during the Affiliated Transactions issue. There, SWB offered as Exhibit 135 a supplemental response to Staff DR #581. The DR response was received by Staff on January 6, 1989 and SWB sought to impeach Staff witness Kiebel's testimony by showing he had not reviewed all DR responses prior to filing his surrebuttal testimony.

Staff objected to the exhibit since it was information dated prior to the date SWB's rebuttal testimony was filed. The exhibit was documentation of certain SWB actions. The objection was sustained because the information was in SWB's possession before SWB filed rebuttal testimony and SWB took the position that documentation of its actions was incidental to its procedures and thus unnecessary. SWB then produces documentation to refute Staff's testimony just days before Staff is to file surrebuttal. The Commission again finds this belated response to DRs to be questionable and does not believe SWB should profit from its delay. Also, Staff witness Kiebel testified he had not seen the DR response, thus he could not have used the information in filing his surrebuttal. If the fact that Kiebel did not view the DR response affects his credibility, the fact he did not review it is in the record. The transcript at page 3208 indicates the Hearing Examiner sustained the objection to the exhibit and therefore Exhibit 135 was not received into the record.

4. Exhibit 270HC

During the course of the lengthy hearings in these consolidated proceedings, several issues arose concerning the admissibility of responses to data requests (DRs). DRs are an approved method of discovery in Commission proceedings. 4 CSR 240-2.090(2). The use of DRs facilitates discovery in Commission proceedings where more formal discovery procedures would unduly delay the exchange of information among the parties. Commission proceedings, especially general rate proceedings, are lengthy and complex and DRs enable parties to obtain information relatively easily in order to prepare their positions.

Because of the number of DRs and the variety of issues involved in Commission proceedings, DR responses are sometimes responded to by persons who are not presented as witnesses, or DR responses are prepared by witnesses but the responses address an issue about which the witness is not testifying. This situation gave rise to the dispute concerning Exhibit 270HC. Exhibit 270HC was a response prepared by SWB witness Mitchell to MCI DR 305. The response involved an issue about which Mitchell was not testifying. Mitchell testified earlier in the hearing on another issue and MCI did not cross-examine Mitchell about the DR response at that time.

MCI sought instead to cross-examine SWB witness Lundy, SWB's witness on the issue addressed by the DR response. Lundy could not identify the DR response and testified he did not use the information in preparing his testimony. Based upon Lundy's inability to authenticate Exhibit 270HC, SWB counsel objected to the DR's admissibility for lack of a proper foundation.

SWB would have the Commission rule that a DR response is only admissible by the person who prepared a DR response or a witness through whom a proper foundation can be laid. SWB asserts that since the DR response is hearsay, it can only be admitted through a proper foundation or as a business record. Staff, MCI, Sprint and AT&T assert that this restriction on the admissibility of DR responses is not required and would unduly complicate discovery and the hearing process.

Adoption of SWB's position by the Commission would allow parties, especially the companies the Commission regulates, to impede the introduction of evidence. Under SWB's position, a party could respond to DRs through an employee who is not then made a witness in the proceeding. If no other witness at the proceeding could authenticate the response, it would not be admitted and thus potentially relevant and essential information would be kept from the Commission.

The Commission holds that responses to DRs by company personnel or agents are admissible into evidence without having to be sponsored by the specific company employee or agent who prepared the response. The responding party has selected the person to respond to the DR on the party's behalf and the person making the response therefore represents the party. The Commission considers these responses to be admissions of the party. Objections may be raised by the responding party as to relevance or that the DR response is not the response made by the party. Based on the Commission's holding, Exhibit 270HC will be admitted into the record.

The Commission's ruling has not addressed the other issue raised, of whether cross-examination about a DR response should be had when the person who prepared the response testifies, even if the witness is testifying on another issue, or should cross-examination only be allowed during the time the issue which is the subject matter of the DR response is heard. Staff contends no limitation should be placed on cross-examination concerning a DR response.

If the Commission allows cross-examination outside of the time an issue is heard, the record will be confused and relevant information perhaps overlooked upon review. If cross-examination is required only during the issue, the responding party will not have an opportunity to conduct redirect examination of the person who prepared the response unless the person who responded to the DR is a witness on that issue. Either alternative allows parties to manipulate the proceedings.

The Commission has determined that the better procedure is to only allow cross-examination about a DR response during the issue which is the subject matter of the response. Since the DR response will not require authentication to be admitted, a party must choose either to make the DR response a part of one of its witnesses' testimony to ensure the responding party's witness will have reviewed it, or risk that there will be no witness to cross-examine on the specifics of the DR response.

The responding party must decide early in the proceeding who should respond to DRs on certain issues and who will be witnesses. The responding party will run the risk of not having a witness who can answer questions on redirect concerning the DR response. The Commission believes that parties will have less freedom to manipulate the proceedings under this procedure.

5. Exhibit 296

Exhibit 296 was reserved for a late-filed exhibit to be filed by SWB. Exhibit 296 will be admitted into evidence.

6. Exhibit 297

MCI filed a response to Exhibit 245. MCI's response was marked Exhibit 297. SWB filed an objection to Exhibit 297. The objection is overruled. Exhibit 297 will be received.

AA. Summary of Revenue Issues

Staff, SWB and PC provided the Commission with a reconciliation of the dollar amounts associated with the issues in these proceedings. The amounts are different depending on what the Commission's decision is on an issue and based upon the starting point of each party's calculation. Staff starts its calculations from its case of a reduction of $205,760,000. Staff's revenue reduction amount is reduced by decisions different from those presented by Staff. SWB's calculations start from a revenue increase of $27,041,000. Where the Commission's decision is different from SWB's position, SWB's revenue is reduced. PC's calculation corresponds to Staff's but includes Public Counsel's issues and total revenue reduction of $206,982,000. PC's revenue reduction is adjusted in the same manner as Staff's.

The Commission has determined that SWB's total revenue reduction as a result of this case is $101,323,000. As part of the Depreciation/Amortization issue the Commission offered SWB an option of amortization of the theoretical reserve deficiency if SWB shared the amortization expense. The value of this option is $5,804,000. Acceptance of this option will reduce the total revenue reduction to $95,519,000.

Issues	Staff $ (000)	Company $ (000	Public Counsel $ (000)
	($205,764)	$ 27,041	($206,982)
1. Rate of Return (12.61% ROE, 10.73% ROR, 54.63% Equity)	24,974	(35,792)	24,974
2. Separations/Part 36	9,730		9,730
3. Part 32	21,999		21,999
4. Test Year/True-up	0	0	0
5. Annualization/Year Ending		(14,118)	
6. TRA Credits		(15,021)	
7. CF.1	(1,318)	(1,318)	
8. Income Taxes:			
a. Amortization ITC & Deferred Taxes Compensation Adjustment	2,150		2,150
b. Pre-1981 COR & Salvage		(1,775)	
c. Vacation Pay	1,916		1,916
d. Business Meals		(1,230)	
e. Capitalized Interest	151		151
f. Interest Deduction		(1,896)	
g. Normalization		(2,042)	
9. Employee Compensation:			
a. Management and Senior Management Salaries	9,953		9,953
b. Nonmanagement Salaries	5,742		5,742
c. MIP		(1,273)	
d. TEAM Awards	4,770		4,770
e. Short Term Incentive		(563)	
f. Long Term Incentive		(829)	
g. Concessions	1,775		1,775
h. SIPP		(2,512)	
10. Cash Working Capital		(3,078)	
11. Complex Inside Wire (update to 6-30-89)	910	(5,116)	910
12. Maintenance of Service Charges		(1,243)	
13. Pay Phone Installation	511		511
14. Net Compensable Property		(1,411)	
15. Billing and Collection		(6,286)	
16. Bellcore	328		328
17. Deregulated Services		(546)	
18. Rate Case Expense	0	0	0
19. Membership Fees, Dues, & Donations			207
20. Contributions	(20)	(20)	
21. SBC	4,657		4,657
22. One Bell Center	1,956		2,808
23. Advertising	4,559		3,380
24. Operator Takeback & TAN		(4,858)	
25. Yellow Pages	6,764	(10,227)	6,764
26. Capital Deployment	2,934		2,934
27. Depreciation/Amortization	6,400	(10,800)	0
28. NET REVENUE REQUIREMENT ADJUSTMENT	($101,323)	($101,323)	($101,323)

	($101,323)
29. Amortization Sharing Option	5,804
30. REMAINING REVENUE REQUIREMENT ADJUSTMENT	($ 95,519)

II. TeleFuture 2000 (Case No. TO-89-10)

On July 19, 1988, SWB filed a proposal to change the way it is regulated by the Commission. This proposal SWB entitled TeleFuture 2000. In August, 1989, both Staff and Public Counsel filed complaints against SWB alleging SWB's rates were excessive and SWB was overearning by over $200 million. The Commission determined that before it could address SWB's proposal for removing SWB from rate base/rate of return regulation there would have to be a resolution of the allegations in the two complaints. The Commission consolidated the TeleFuture 2000 proposal with the two complaints and an inquiry into SWB's rate design. The Commission has now heard the evidence in these matters and by this order has reduced SWB's revenue requirement. This section of the order will address the TeleFuture 2000 proposal.

TeleFuture 2000 contains several elements, portions of which could be related to Revenue Requirement issues. SWB, though, has repeatedly maintained that the TeleFuture 2000 proposal is a whole and interdependent proposal not severable into its various elements.

In its initial pleading SWB requested the Commission (1) eliminate all party line service by the end of 1993 and significantly reduce urban mileage charges applicable to basic local service outside the base rate area (OBRA), (2) extend the credits to residential customers agreed to in Case Nos. TR-88-23 and AO-87-48 until June 30, 1989, (3) freeze residential rates from July 1, 1989 to June 30, 1990, and (4) beginning July 1, 1990 residential rates would be increased or decreased based upon the U.S. Consumer Price Index (CPI) with a three percent offset for productivity and a maximum allowable annual increase of 50 cents a month. In addition, SWB proposed to replace all Crossbar and Step-by-Step switches with digital switches within five years and replace existing interoffice cable with fiber optic cable. SWB also sought to reclassify all nonbasic services as transitionally competitive under the provisions of Section 392.361, R.S.Mo. (Supp. 1988).

Once a procedural schedule was adopted for considering the TeleFuture 2000 proposal, SWB extended the residential credits through June 30, 1989. The treatment of the revenue to be generated from the elimination of these credits is addressed in the Revenue Requirement portion of the Report and Order. The Commission established Case No. TO-89-56 to address the classification of SWB services as transitionally competitive. That docket is being heard on a separate schedule. The remaining elements of TeleFuture 2000 will be addressed in this section.

Since the TeleFuture 2000 proposal is to be viewed as interdependent and not subject to approval of some elements and not others, the Commission needs first to address the issue of the proposal's legality. This focus is centered on the proposal to adjust rates based on fluctuations in the CPI. (More specifically, the CPIU - all urban customers.)

SWB's witness Kaeshoefer discussed how rates would be set using the CPI. Under SWB's proposal price increases and decreases would occur as a result of changes in the CPI subject to certain limitations. SWB proposes, under the CPI plan, to file enabling tariffs to reflect the new rates which result from the CPI for the previous year. Flat rate one-party residential rates would increase 25 cents if the CPI was from 4.1 percent to 6 percent. If the CPI was over 6 percent the monthly flat rate one-party charge would increase 50 cents, 50 cents being the maximum increase allowable under the plan. The increases start at 4.1 percent because of the offset of a 3 percent productivity factor. The flat rate one-party residential rate would decrease 25 cents if the CPI was between 0 percent and 2 percent.

Several parties attacked the CPI element of TeleFuture 2000 as unlawful, claiming it would violate the provisions of Chapter 392 which requires the Commission to examine all relevant factors in establishing just and reasonable rates. The basis of the challenge to the CPI is the Missouri Supreme Court decision concerning the fuel adjustment clause (FAC) approved by this Commission for electric utilities. UCCM v. P.S.C., 585 S.W.2d 41 (Mo. banc 1979).

Based upon an analysis of the court's holdings concerning the FAC and the similarity of the CPI proposal to the FAC, the Commission has determined that it does not have the authority to implement a mechanism which changes rates based upon a single factor. The FAC decision strikes at the heart of the CPI proposal and the CPI proposal suffers from the same defects as did the FAC.

The recitation of several of the court's holdings will demonstrate the similarity and thus the result. First it should be noted that the Commission has only that authority conferred by statute. Neither convenience, expediency or necessity are proper considerations in determining the limits of the Commission's authority. UCCM at 48. The court rejected the FAC because it was an automatic pass-through without any consideration for compensating decreases in other operating expenses, and the court held use of the FAC was a radical departure from the usual practice of establishing rates in the context of a general rate increase. UCCM at 49. Even when the Commission allows rates to go into effect without suspension it must consider all relevant factors including operating expenses and the utility's rate of return. UCCM at 49. The court held that by adopting the FAC the Commission was instituting a new method of generating rate increases not within the contemplation of the statutes. UCCM at 53.

The court pointed out that under the current method of setting rates the Commission must fix the maximum rate, and before a new rate can be fixed the Commission must consider all relevant factors. UCCM at 53, 56. The approval by the Commission of the FAC permitted one factor to be considered to the exclusion of all others. UCCM at 56. The court went further and held that approval of the FAC in advance even if not the actual rate filing was also unlawful and the advance approval in effect shifted the burden of proof away from the utility. UCCM at 57. The court held that the Commission cannot abdicate the responsibility to determine, based upon other cost factors, whether the proposed rates are just and reasonable. UCCM at 57.

As can be seen from the court's holdings, the Commission is without authority to approve the CPI proposal. The CPI would allow a rate increase based upon a single factor without consideration of the expenses of the utility and the utility's rate of return. The CPI is a radical departure from the usual method of setting just and reasonable rates and as such is not contemplated by Chapter 392. The Commission finds, therefore, that it cannot approve the CPI element of TeleFuture 2000 and thus cannot approve TeleFuture 2000.

As described by the court in the UCCM case, the purpose of the statutes establishing public utility regulation was to protect the consumer against the natural monopoly of the public utility as a provider of a public necessity while at the same time permitting recovery by the utility of a just and reasonable return. UCCM at 47. The Missouri courts have stated that competition in the provision of public utility service would likely lead to waste and the Commission to be effective must possess the power of intelligent visitation and plenary supervision of every business feature to be finally reflected in rates and quality of service. UCCM at 47 (case cites omitted).

The Commission has determined it does not have the statutory authority to adopt a rate-setting procedure such as the CPI proposal. The Commission is not convinced that even if it had the authority that the CPI proposal presented by SWB would be approved. The CPI only reflects certain portions of national price increases and is not related to company-specific information. The Commission does not believe rates based upon a national CPI would be reasonable. As discussed in relationship to other issues, each company is different and rate adjustments should be based upon an individual company's expenses, revenues and investment. The CPI does not meet this criterion. Also, SWB's projections indicate that using the CPI to adjust rates would require rate increases over the next several years even though SWB's overall cost of providing service is declining.

The Commission recognizes that the telecommunications industry in Missouri is no longer an end-to-end monopoly, but has been in transition to a more competitive environment for several years now. The legislature recognized the need for more flexibility in regulation of telecommunications utilities by the new statutory framework enacted in 1987 (H.B. 360). SWB recognized this new framework by requesting that some of its services be classified as transitionally competitive.

The new provisions of Chapter 392, though, do not change the traditional method for setting rates except where the Commission has classified a service as either transitionally competitive or competitive. For those services so classified rates may be changed under certain circumstances without prior Commission approval. The new statutory framework accommodated the increased competition in the area of telecommunications services but did not remove or expand the Commission's authority or responsibility to look at all relevant factors when setting rates in the context of a general rate case.

Even though the Commission has determined that it is without authority under Chapter 392 to adopt the CPI portion of TeleFuture 2000, the Commission would strongly encourage SWB, Staff and Public Counsel to explore other methods of addressing SWB's concerns which would be lawful. Classification of services pursuant to Section 392.361 with relaxed regulatory requirements should address some of the concerns of increased competition. Incentive plans may also be considered to determine whether they meet the requirements of UCCM and whether they provide adequate safeguards both for the company and ratepayers.

The determination that automatic rate adjustment mechanisms of TeleFuture 2000 cannot be adopted is not a rejection of network modernization. The Commission believes network modernization should proceed based upon economic as well as non-economic factors. The Commission determined there should be no adjustment to SWB's revenue requirement for costs associated with the digital replacements at issue in the Revenue Requirement portion of these proceedings. The Commission determined that it was reasonable for SWB to make the replacements even though each replacement may not have been economically justified. Since the Commission has not adjusted SWB's rates for its network modernization in this case, those funds will be available for additional modernization in the future. Based upon its determination in this case, the Commission would not expect future adjustments to be made if SWB continues to improve its CUCRIT analyses and proceeds to modernize its network on a reasonable timetable.

SWB witness Hubbard testified that SWB was not seeking approval to implement its network modernization proposal under TeleFuture 2000. The Commission agrees that SWB does not need Commission approval to proceed with network modernization. Whether SWB accelerates its modernization as proposed in TeleFuture 2000 or proceeds more slowly is an SWB management decision. The Commission encourages SWB to complete its modernization within a reasonable time frame. The evidence in this case indicates sufficient funds are available to proceed. Even the TeleFuture 2000 proposal contained lower costs for network modernization, not including mandatory one-party service, than SWB has spent in recent years on modernizing its urban system. The Commission is interested in the timetable SWB decides is appropriate and will ask that the Commission be notified of the network modernization timetable SWB develops after this case.

Whether SWB should replace all 112 electromechanical switches in five years is a management decision which SWB must make. The evidence indicates that the sooner the replacements are made the more benefit SWB will receive from the decreased costs and increased revenues associated with the digital switches and fiber optic cable. Even with the revenue reduction ordered in this case SWB should be able to proceed with replacement. SWB's expenditures for urban modernization are ending, which will release more capital to be expended for the nonurban exchanges. This is especially true in light of the small portion of SWB's overall capital investment budget that would be required by the digital switch replacements and the fiber optic installation.

Under TeleFuture 2000 SWB proposed to phase out party line service by the end of 1993. SWB also proposed to reduce the existing multiband mileage rate structure to only one mileage band and to set the rate at $2.05. The change would mean a decrease in mileage charges for some customers and no customer would experience an increase in mileage charges. The Commission has approved the one mileage band rate structure in the Rate Design portion of this order.

The elimination of multiparty service would cause a rate increase to current party line customers. SWB proposed to grandfather the party line rate for customers who are upgraded to one-party service if SWB initiates the upgrade. If the customer requests the upgrade, the customer would pay the single-party rate.

The party line proposal was part of the network modernization aspect of TeleFuture 2000. The Commission has encouraged SWB to continue its network modernization and this encouragement includes elimination of party line service. As SWB installs more digital switches, party line service will become more of an anomaly and SWB will incur additional costs to maintain party line service. The Commission encourages SWB to consider eliminating party line service as it installs digital switches.

III. Rate Design (Case No. TO-89-29)

As part of these consolidated proceedings, the Commission held hearings on the rates which should be reduced depending upon the amount of any revenue reduction ordered in the Revenue Requirement portion of this case. The parties presented their proposals concerning rate design by priority since the amount of the reduction had not been determined at the time of the rate design hearings. Staff presented a matrix which detailed the priority of its proposed rate reductions based upon different levels of an ordered revenue reduction. PC presented its own priorities, with the majority of any revenue reduction going to reduce basic local exchange rates.

SWB presented its priorities for any revenue reduction, recommending that no reduction be made in basic local exchange rates. Other parties presented individual rate reduction proposals while MCI also proposed the Commission adopt a new method for pricing SWB's services.

Several agreements were reached by interested parties concerning how certain rates should be reduced or changed in this proceeding. Rates addressed by these agreements were considered of more or less importance by signatory parties. Other rate changes were proposed by interested parties but with differing priority. The Commission has considered the proposals and their relationship to the total revenue reduction ordered in this case. The Commission will address the rate changes it has adopted first and then will address those proposals it did not adopt.

A. Joint Recommendation

Staff and SWB presented a Joint Recommendation to the Commission to make rate adjustments to various components of analog private line, analog special access, digital private line (digital link services) and digital special access. The proposed adjustments would increase the affected rates, thus increasing SWB's revenue by $3.147 million. The proposed rate increases are based upon recent cost studies which show that these rates are not recovering their costs. The changes which are proposed to be made to individual rate elements are detailed in Attachment A to the Joint Recommendation.

Staff has indicated that rate increases for these services are proposed for rate elements which are currently priced below cost and increasing in quantity. These rates would be increased above cost to provide a contribution. Rate elements which are below cost but for which quantities are either remaining steady or decreasing in quantity would be increased to cost, except for 100 analog private line services. The 100 analog private line services, which are commonly subscribed to by the alarm industry, would not be increased all the way to cost because of the substantial effect on customers the full move to cost would have.

Additional rate changes are proposed in the Joint Recommendation which would ensure that digital link services and digital special access would provide a contribution and that the rate structures for these two general types of services would be the same and also match interstate special access rates. All nonrecurring charges associated with analog private line, analog special access, digital link services, and digital special access would be increased to cost.

The Commission has considered the Joint Recommendation and has determined the proposed rate changes are reasonable. The Commission is not convinced that rate increases for particular services are entirely appropriate in an overall rate reduction case, but has determined that the proposal regarding private line service will be adopted. When new cost studies indicate a service or elements of a service are not recovering costs, it is appropriate to adjust rates to ensure that rates do cover costs. The increases in rates are also reasonable since reductions in the private line portions of foreign exchange (FX) rates are proposed which offset most of the increase in revenue.

B. Stipulation and Agreement on Service and Connection Charges

SWB, Staff, PC and DOD filed an agreement proposing a reduction in service and connection charges. The Stipulation indicates that this agreement is among all of the parties which have expressed a position on these rates. The individual rates proposed to be changed are detailed in Attachment A to the Stipulation. The adoption of the proposed rates would decrease SWB's revenue by $9.648 million annually. In addition, SWB agrees to complete service connection charge cost studies in 1991 utilizing time and motion studies on all labor intensive elements for which time and motion studies were conducted in support of the 1984 or 1990 service connection charge cost studies.

The Commission has considered the proposed changes and has determined they are reasonable. A review of the individual services shows that some of the reductions are substantial. The reductions which will occur will benefit both business and residential customers who add new services, change their type of service, move to a new location, or require other similar services from SWB.

C. Stipulation and Agreement on Mileage Charges

SWB, Staff and PC filed an agreement which proposes to reduce SWB's existing multiband urban mileage rate structure to one mileage band. The rate for the remaining band would be the current lowest mileage rate of $2.05 a month. The revenue effect of this proposal is a reduction of $4.664 million in SWB's revenue.

The Commission has determined that this proposal will be adopted. The proposal for one mileage band was also a part of SWB's modernization plan under TeleFuture 2000. The Commission has indicated its approval of reasonable network modernization expenditures. The Commission could not approve the entire TeleFuture plan as proposed by SWB, but has determined this part of the proposal is beneficial to customers outside base rate areas and should be implemented.

D. Stipulation and Agreement on Customer-owned Pay Phones

SWB, Staff and the Midwest Independent Coin Payphone Association (MICPA) filed an agreement with the Commission to change SWB's tariffs and rates related to customer-owned pay phones. The three parties, which are the only parties taking a position on these rates, propose that rates be set based upon the most recent cost studies, that usage charges for local calls be based upon per minute of use rather than per call, and that charges for directory assistance calls provided by SWB will not be charged to customer-owned pay phones. In addition, SWB has agreed to enforce the provisions of its customer-owned pay phone tariffs by notifying the customer-owned subscriber of any violations. SWB and Staff agree that this proposal will cause a decrease of $154,000 in SWB's revenues. MICPA had not verified this amount but did not object to it.

The Commission has reviewed the Stipulation and has determined that the proposal concerning customer-owned pay phones is reasonable and will be adopted. The Commission finds it is reasonable to base rates on the most recent cost study information. The other changes will eliminate some of the problems which have existed between SWB and customer-owned pay phone subscribers.

E. Stipulation and Agreement on Customer-owned Equipment Trouble Isolation Charge

SWB, Staff and PC filed an agreement which proposes to reduce the charge paid by customers whenever SWB visits the customer's premises to check for trouble. SWB currently charges $25 under its Customer-owned Equipment Trouble Isolation Charge (COETIC) for each visit where the trouble is found to be in the customer's line or phone. By the agreement, customers without a Network Interface Device (NID) on their line would be charged $5 per visit, while customers with a NID would be charged $37 per visit. This proposal would reduce SWB's revenue requirement by $22,000. The agreement also includes customer education procedures.

The Commission has considered this proposal and has determined that it is reasonable and will be adopted. Under current procedures a customer, even though he now owns both the inside wire and telephone instruments, must call SWB when there is trouble so that it can be determined whether the trouble is in the customer's facilities or in SWB's facilities. The installation of NIDs on each line will enable the customer to isolate the trouble, and then the customer can choose whether to call SWB if the trouble is in the customer's equipment. Thus the differentiation in rates between those premises with a NID and those without is reasonable. SWB is encouraged to install NIDs as soon as practical in all premises.

F. Foreign Exchange Service

Foreign exchange (FX) service is a service where telephone customers in one local exchange purchase a telephone number and listing in another local exchange so the customer can make and receive calls between the two local exchanges without toll charges. The City of Oak Grove's witness Dunn proposed that FX rates should be divided into two separate services with different pricing methods and therefore different rates. Dunn proposed that where there is a community of interest, as between Oak Grove and the Kansas City metropolitan area, FX rates should be priced residually as are basic local exchange rates. Under Dunn's proposal FX service which substitutes for long distance service would be priced based upon long run incremental analysis.

As part of its proposal to increase rates for certain private line services, Staff proposed to reduce two elements of FX service. Staff's proposal would reduce FX rates between Oak Grove and the Kansas City metropolitan area by 55 percent. SWB opposes any reduction in FX rates but especially opposes pricing of FX based upon a community of interest standard.

A review of the evidence on this issue reveals that Oak Grove's proposal is a continuation of the extended area service (EAS) controversy which the Commission has addressed extensively in Case No. TO-86-8 and is now addressing in Case No. TO-87-131. Dunn admits that his FX proposals for Oak Grove are a proposed resolution to Oak Grove's EAS problems. Oak Grove has raised the same concerns and presented the same evidence and arguments in other cases before the Commission.

The Commission has determined that FX service is not a basic local service which should be priced residually. The problem of calling between persons in exchanges outside metropolitan calling areas and the metropolitan areas is being addressed by the Commission in Case No. TO-87-131. Proposals to resolve the calling scope problems should be made in that docket and are not appropriate when dealing with just one of the affected local exchange companies.

The Commission finds that the evidence supports some reduction in the elements of FX service. The level of contribution made by FX customers is substantial and should be reduced. Staff's proposed reduction in the FX service rates will reduce total FX charges substantially. The reductions are as set out below:

	Present Rate	Staff Proposed Rate
Interexchange Channel Terminal (2 required)	$27.90	$11.40
Point of Termination (1 required) 0-20 V-H miles between exchanges;	61.10	12.35
over 20 V-H miles between exchanges	70.70	12.35

These reductions would reduce the total amount an Oak Grove customer would pay for FX service from $203.50 to $121.75 for business, and from $165.95 to $84.20 for residence. The Commission has determined these reductions are reasonable based upon the contribution levels of current FX rates. FX service, though, is not nor is it intended to be a substitute for EAS. Proposals, such as Oak Grove's, to establish amorphous criteria such as a community of interest cannot be addressed piecemeal. Those proposals are more appropriately presented in Case No. TO-87-131 where they can be dealt with on a statewide basis.

The adoption of reduced FX rates will decrease SWB revenues by $2.228 million.

G. Touch-Tone

SWB, Staff and PC each recommend some reduction in Touch-Tone rates. Staff proposes reductions of 10, 30 or 50 percent in Touch-Tone rates depending upon the total overall reduction in revenue ordered by the Commission. PC proposes that the current monthly Touch-Tone rates for residence customers be reduced from $2.05 to $1.65, for business from $4.40 to $3.55, and for central office trunk from $9.40 to $7.60. SWB proposes that only the central office trunk rate be reduced and that from $9.40 to $4.40.

As new digital replacements are made, Touch-Tone will increasingly become part of basic telephone service. Once a digital central office is installed, rotary dials will require special equipment to make calls. The Commission has determined some reduction in Touch-Tone rates is necessary to reflect this changing technology. A reduction in PBX central office trunk rates is also warranted to reduce the administrative difficulty SWB has in determining whether a customer is using multiline or a PBX. As customers install more advanced technology, it becomes harder for SWB to determine which rates to apply.

Based upon the above evidence the Commission has determined that residential and business Touch-Tone line rates will be reduced 30 percent and PBX trunk rates will then be reduced to the same level as business Touch-Tone line rates. If SWB does not accept the amortization sharing option, the $5,804,000 associated with that option shall be used to further reduce Touch-Tone rates across the board.

H. InterLATA/IntraLATA CCL Rate Parity

All interested parties except PC support a reduction in the interLATA carrier common line (CCL) charge to the level of the intraLATA CCL charge. The interLATA CCL charge was set when the Commission eliminated the interLATA access pool. WATS Resellers, et al., 28 Mo. P.S.C. (N.S.) 534 (1986). The intraLATA CCL charge was set when the intraLATA toll pool was eliminated and replaced by the Primary Toll Carrier Plan. RE: WATS Resellers, et al., 29 Mo. P.S.C. (N.S.) 749 (1987). These rates were set based upon calculations made to eliminate each pool on a revenue-neutral basis.

Interexchange carriers (IXCs) such as AT&T, Sprint and MCI have continually sought to have the interLATA CCL charge reduced to the intraLATA CCL level. The IXCs have argued that the differences in the charges are discriminatory and not supported by any difference in service.

The Commission has rejected the discrimination arguments in the past and does so now. Differences existed in the service between interLATA and intraLATA access which supported a difference in the rates. The Commission has resisted earlier attempts to reduce the interLATA CCL charge to the intraLATA level because of the substantial effect such a move would have on basic local rates. In this case, though, since a reduction in SWB's rates is being ordered, the Commission has determined the reduction is reasonable.

Bringing the two CCL rates into parity is consistent with the shift of non-traffic-sensitive (NTS) costs reflected in current intraLATA CCL charge. The reduction of the interLATA CCL charge to parity will reduce the pressure of bypass, switching to special access on SWB's system, and will increase administrative efficiency.

Even though the threat of bypass may not be as great as SWB contends, the threat still exists. Parity of CCL rates should help reduce the threat.

The evidence does not support PC's other arguments against parity. Across-the-board changes in toll rates will maintain the price relationship between short haul and long haul. There is no evidence these relationships will not be maintained. The fact that interLATA CCL minutes exceed intraLATA minutes does not weigh against the move to parity. Raising intraLATA CCL rates in the context of this case is not reasonable. The Commission expects the IXCs to flow through the reduction in interLATA CCL rates to their customers and thus provide an additional benefit to customers from the parity. Commission Staff should monitor IXC tariffs to determine whether the reductions are made.

In conjunction with parity between the interLATA and intraLATA CCL rates AT&T has proposed the Commission cap SWB's recovery of NTS costs from intrastate toll. AT&T has proposed the Commission adopt a mechanism similar to that approved for secondary carriers (SCs) under the Primary Toll Carrier Plan adopted by the Commission to eliminate the intraLATA toll pool. Under the proposal SWB would charge IXCs, primary toll carriers (PTCs) and itself for an initial block of usage up to 1987 test year level. Any additional usage would be priced at zero.

The Commission has determined that AT&T's proposal to cap NTS cost recovery is not reasonable. The cap for SCs was developed to implement the Primary Toll Carrier Plan and eliminate the intraLATA toll pool. The cap for SCs was part of the negotiated settlement and is an inappropriate reference point for IXCs.

In addition, the Commission agrees with Staff witness Goldammer concerning the cap. Goldammer testified that a capping mechanism is relevant only when switched access rate components are associated with a cost standard. No cost standard has ever been established for switched access rate components for intrastate LEC operations. The components of LEC CCL rates were set residually when the toll pool was eliminated to achieve revenue neutrality. Therefore, there is no basis for setting a cap for NTS costs as proposed by AT&T.

AT&T also proposed a sharing of reduction in costs associated with changes in SWB's taxes based upon the TRA. The Commission has included costs and revenues associated with the new tax rules under TRA and the elimination of the TRA credits in determining the revenue reduction in this case. AT&T and other customers will share the benefits from TRA through the rate reduction approved in this order.

I. Other Switched Access Rates

In addition to the parity proposal discussed above, the Commission has determined that other changes are reasonable for switched access services. These changes are proposed by SWB and include elimination of special access surcharges and reseller credits, changes to access transport rates, and changes to end office rate elements.

SWB proposes to eliminate the special access surcharges to intrastate WATS and 800 service access lines. The surcharge is $25 and is billed to the WATS/800 customer. The surcharge results from the implementation of access charges by the FCC upon divestiture. Approximately 97 percent of interstate WATS/800 Access Lines (WALs) are exempt from the surcharge but the intrastate tariffs have, since divestiture, contained the special access surcharge. SWB witness Bailey testified that there are no costs associated with the surcharge.

The Commission has considered these reductions and has determined that since there are no costs associated with the surcharge it is reasonable to eliminate it from SWB's tariffs. The reduction will reduce the price of a WAL and make the rate more competitive.

The reseller credits which SWB proposes to eliminate are provisions in SWB's access tariff which resellers of MTS/WATS service use to obtain access services at less than the standard rates charged to other IXCs. These reseller credits include (1) the ability to originate traffic over local exchange lines; (2) the WATS prorate credit; and (3) the suspension of CCL charges when a reseller uses trunk side FGB and FGD connections to resell WATS. These credits enable a reseller to pay less for access than other IXCs. SWB does not propose to eliminate reseller credits for resold MTS.

The evidence indicates that the reason for the reseller credits is no longer valid. The credits were implemented by the FCC to lessen the effect of access charges on resellers. The FCC has eliminated the credits for interstate tariffs. The Commission has determined the reseller credits should also be eliminated from intrastate tariffs. Under the credits, SWB is providing service to some resellers below cost, which is inappropriate. The Commission is not convinced that the elimination of the credits will hinder competition in rural markets. Elimination of the tariffs will prevent some IXCs from subsidizing service to other IXCs.

SWB and Staff propose reductions in switched access rates. SWB's proposal would reduce only the two longest access transport rate bands while Staff would reduce switched access rates by 20 percent across the board. The amount of revenue reduction does not reach the level set by Staff to implement its proposal but the Commission has determined that the reduction of switched access rates is of a higher priority than that proposed by Staff. Staff also indicated it supported SWB's proposal if Staff's 20 percent reduction would reduce some of the band rates below cost.

The Commission has determined that SWB's proposal should be adopted. The two longest access transport rate bands, "25-50" and "over 50", would be reduced to be in parity with interstate rates. The reduction of these rate bands will reduce any incentive for IXCs to create additional points of presence (POPs) closer to an SWB end office to take advantage of the shorter transport band rates. The reduced rates for the longer transport rate bands will aid rural areas served by SWB by reducing toll charges for more remote areas. This reduction should also increase competition in rural areas since IXCs' access charges will be reduced for the longer bands.

SWB also proposes to merge the existing local switching, line termination and intercept rate elements into a single end office rate element. This merger would eliminate the intercept rate and bring the rate structure in line with current interstate rate structure. The Commission has determined this proposal is reasonable.

J. WATS/800 Service

WATS, as described by SWB witness Kaeshoefer, is an outgoing intraLATA calling alternative to SWB's Long Distance Message Telecommunications Service (LDMTS). SWB proposes that the WATS first usage band business day rates be reduced by 32 percent and subsequent band rate steps be tapered by 15 percent below the preceding band rate. SWB proposes to continue evening and night/weekend discounts. This reduction would result in a reduction in SWB revenues of $1.1 million.

The Commission has determined that the reduction in WATS rates proposed by SWB is reasonable. Since the Commission authorized intraLATA competition, 20 providers now offer intrastate WATS in competition with SWB. Because of this competition SWB has experienced a 37 percent decline in hours of usage, a 29 percent decline in lines in service, and a 36 percent decline in average monthly usage revenue. As competition increases and SWB's revenues decrease, it is reasonable to allow a reduction in SWB's WATS rates to make them competitive and thus stabilize or generate the revenue received by SWB from this service.

800 Service is a WATS arrangement that allows calls to be placed to an 800 Service customer without cost to the calling party. SWB proposes a reduction in 800 Service rates by lowering the first usage band business day rates by 12 percent. Subsequent usage band rates would be priced at 15 percent below the preceding band rate. SWB proposes to continue the discounts for evening and night/weekend calls. Adoption of this proposal would result in a revenue reduction of $2.7 million.

The Commission has determined the proposed reduction to 800 Service band rates is reasonable. 800 service is subject to the same competitive pressures as WATS service. Sixteen companies compete with SWB in offering 800 service. SWB has not experienced the declines in revenues, lines and hours for 800 Service as it experienced for WATS. In 1988, though, declines were experienced in revenues, lines and hours from 1987.

In addition, SWB is prevented from offering a full intrastate 800 service since it can only offer intraLATA 800 service except by jointly providing the service with an IXC. Since SWB's 800 Service can only be provided intraLATA unless provided jointly and the 1988 revenues, lines and hours show declines, it is reasonable to reduce 800 Service rates to stabilize and possibly generate additional revenue from 800 Service.

SWB also proposes to change the structure and price of intrastate WATS/800 Access Lines (WALs) provided jointly by SWB. Under the current structure the WAL is recovered from both the WATS tariff and the Access tariff. The end user is charged the WAL rate from the WATS tariff by SWB, while the joint IXC provider is charged a WAL rate from the Access tariff. The joint IXC provider then bills the end user a WAL charge from its WATS tariff.

Under SWB's proposal the WAL charge would be consolidated with the WAL access charge to the joint IXC provider. The joint IXC provider would then cease billing the end user a WAL charge. SWB would then charge the end user a single WAL rate for both WATS and 800 Service of $43.00. Adoption of this proposal will increase SWB's revenue by $.6 million for intrastate WATS/800 WAL and decrease SWB's revenues from Special Access WAL by $2.4 million. The result would be a reduction of $32.70 for each 800 WAL customer and of $6.20 for each WATS WAL.

There seems to be no opposition to the changes in the WATS/800 Access Line rates as proposed. The Commission has determined that the changes are reasonable.

The reduction of rates to the end user is beneficial and the simpler billing should also aid the end user.

K. Optional Toll Plans

SWB proposed two optional toll plans in this proceeding. One plan is a discount plan which would be available to both business and residence customers. Under the plan residence customers could choose to pay $2.00 a month to receive a 35 percent discount on all intraLATA toll usage charges which occur during the evening rate period and a 50 percent discount for toll usage charges which occur during the night/weekend period. This would provide customers who choose this plan an additional 15 percent discount for these periods. Business customers would have three options for intraLATA toll usage for all three rate periods: day, evening, night/weekend.

The second plan would offer only residence customers an hour of intraLATA toll usage in the evening and night/weekend rate periods for a $10.00 a month charge. The $10.00 would be billed regardless of whether the customer used all 60 minutes of calling time. Additional hours of usage would be billed at $9.00 an hour prorated for fractional hours of usage.

The Commission has determined that reductions in SWB's revenue for these optional calling plans are not reasonable. The Commission has determined that new optional plans are not an appropriate method of reducing SWB's revenue in this proceeding. The revenue reduction amounts SWB suggests are associated with these plans are speculative since SWB has no method of ascertaining customer participation. In addition, under SWB's proposal the Commission would adopt the plans for a one year experiment with a true-up to make adjustments if customer participation is not as projected. This procedure would only delay and distort the revenue reduction ordered. Although the Commission does not disapprove of optional discount or block plans in general, these plans will not be adopted in these proceedings.

L. Direct Inward Dialing (DID)

SWB proposes to reduce recurring DID service trunk termination and DID number group prices by 20 percent. Although AT&T initially proposed a greater reduction in these rates, it now supports the 20 percent reduction while reserving the right to challenge the reasonableness of the rate in any future proceeding.

The Commission has determined the proposed 20 percent reduction is reasonable. The evidence is that current DID rates for PBX customers provide contributions of 200 percent through trunk termination rates and 600 percent through number group prices. Reducing the contribution levels of these services is reasonable.

M. Long Distance Message Toll Service (LDMTS)

SWB and Staff have proposed at least a 5 percent reduction in SWB's LDMTS rates. Staff proposed a 15 percent reduction if the total revenue reduction ordered by the Commission reached $150 million. PC, MCI and Sprint oppose any reduction in these long distance rates.

The Commission has considered the reduction of intraLATA toll rates, LDMTS, weighing the positions of the parties and the other reductions found to be reasonable. Arguments concerning the amount and effect of competition on SWB and strict adherence to pricing principles of Case No. 18,309 as espoused by PC and MCI are relevant considerations, but are not determinative. Arguments concerning whether 10XXX calling is a substitute for SWB's 1+ calling are also not determinative. More important to the Commission is how best to return the revenue reduction to be ordered in this proceeding to SWB's customers.

The Commission has determined that reductions of basic local exchange rates are not warranted. Those rates are set at a reasonable level. Since the Commission has found that basic local exchange rates will not be reduced, the next service which affects a substantial number of customers is long distance service.

The Commission has been presented with a continuing series of cases concerning toll rates in EAS cases. IntraLATA toll rates are a part of this problem.

In addition, customers do not understand why intraLATA long distance calls are substantially more than interstate calls. A reduction in intraLATA long distance rates would reduce some of this customer frustration.

The Commission is aware the evidence is that 41 percent of residence customers and 31 percent of business customers have an intraLATA bill of $1.00 or less per month. This Commission, though, believes these percentages are distorted by SWB's Wide Area Service Plans (WASPs) in Kansas City and St. Louis. SWB customers outside these metropolitan areas must make toll calls where those inside the WASPs do not. A reduction in LDMTS would benefit these customers. A reduction would also benefit customers of independent telephone companies which are located in exchanges where SWB is the primary toll carrier.

Based upon these considerations the Commission has determined that after reductions are made for the other rate changes in this order, the remaining revenue reduction should be used to reduce LDMTS rates. This would be approximately a 20 percent reduction in LDMTS rates.

Both PC and MCI have contended throughout the rate design proceeding that Case No. 18,309 requires a reduction in basic local rates first and allows reductions in nonbasic rates only if the reduction either maximizes contributions or meets an economic or social goal. RE: Southwestern Bell Telephone Company, 21 Mo. P.S.C. (N.S.) 397 (1977). As stated in the discussion of 18,309 in the Basic Local Rates section, a strict adherence to this interpretation of 18,309 is not logical. The pricing policy was not designed to prevent reductions in nonbasic rates.

In addition, as discussed above a reduction will reduce the substantial difference between intraLATA long distance rates and interstate rates and will facilitate intraLATA long distance calling. The reduction of the intraLATA long distance rates seems particularly appropriate in a revenue reduction case since there is no revenue increase offset necessary from other services.

N. Directory Listings and Custom Calling Features

Staff proposed that directory listings and custom calling features be reduced by 20 percent if the revenue reduction ordered by the Commission was over $100 million. Directory listings include extra, additional, alternative, foreign, access service, secretarial listings, supplemental address information, nonpublished and nonlisted number services.

The Commission has determined that it is not appropriate to reduce these services in this case. The Commission has determined the prices for these services are reasonable and there is no compelling evidence that reductions are needed.

O. 10XXX Differential

Sprint has proposed that the Commission establish a differential between intraLATA access 1+ and 10XXX traffic. The differential would reflect the different quality of access IXCs provide because they can only offer 10XXX calling. Sprint contends that IXCs are placed at a competitive disadvantage because of their lack of 1+ dialing for intraLATA calls. Customers using IXCs' intraLATA switched services must dial five extra digits (10XXX) to complete a call. Sprint proposes a 35 percent differential.

There is no evidence to support the 35 percent differential sought by Sprint. For the Commission to adopt the differential, it must base its decision on a differential created in a different case for different services. The Commission has determined such a decision would be arbitrary and thus it will not adopt the differential proposed by Sprint.

P. Basic Local Rates

PC proposes that a substantial portion of any revenue reduction be reflected in reduced basic local exchange rates. Staff proposes that basic local rates be reduced residually as its priority rate design changes are made. PC's initial reduction would reduce local rates by $83.966 million while Staff's matrix for a $75-$100 million reduction would reduce local rates between $33 and $56 million.

PC cites two basic reasons to support its proposed local rate reduction. Those bases are the promotion of universal service and the requirements of the Commission decision in Case No. 18,309. RE: Southwestern Bell Telephone Company, 21 Mo. P.S.C. (N.S.) 397 (1977). Staff also cites the decision in 18,309 to support its proposals for reducing local exchange rates.

Basic local exchange rates include both residential and business access rates. Basic residential local access line rates include flat, message and measured one-party services; the flat and message rate two-party services; the flat four-party rates; the residential flat trunk service; and all residential lifeline service rates. Business basic access line rates include flat, message and measured one-party service; semipublic; four-party service; flat, message and additional message trunk rates; multiline; information terminals; and shared tenant service rates.

The Commission has determined that there should be no reduction in basic local business or residential rates as a result of the revenue reduction ordered in this proceeding. The Commission agrees with PC that ensuring universal service is still the primary goal in setting basic local rates. However, SWB has a 93.62 percent penetration level in Missouri, which is above the national average usage penetration level, and has increased over recent years. In addition, the Commission has approved plans for persons needing assistance in affording telephone service through SWB's Lifeline Telephone Service and Link-Up Missouri plans. The Commission does not believe a reduction below current rates would significantly increase SWB's penetration beyond what these two programs will accomplish.

The Commission has reduced service connection charges in this order based upon an agreement of PC, Staff and SWB. These reductions are more likely to have a greater effect on increasing penetration levels than will a reduction in local rates.

SWB's basic local rates have not been increased since divestiture and are reasonable rates for the quality of telephone service provided by SWB. Even though a customer must now pay the end user common line (EUCL) charge of $3.50 as set by the FCC, the Commission has determined it would be inappropriate to reduce local rates to match the EUCL. The FCC determined that the EUCL should be paid by local customers and the FCC has reduced interstate toll rates as an offset. In this proceeding there is no specific evidence identifying the cost of basic local exchange service. To reduce basic local rates merely to reverse the FCC's prescribed EUCL, without other cost of service information, would be arbitrary and unreasonable.

The Commission has determined that based upon the evidence in this case, reductions in other services are more appropriate than a reduction in basic local rates. The reductions approved by the Commission in this case do not violate the pricing policy established in Case No. 18,309. That pricing policy established three categories of service. Category One services are those services subject to substantial competition. Category Two services are basic local services. Category Three services are all other services offered by SWB.

The Commission in Case No. 18,309 stated that Category One services would be priced so as to generate the largest practical level of contribution. Category Three services would be priced using long run incremental analysis adjusted for social or economic factors. Category Two services would be residually priced after taking into consideration any contribution to revenue requirement made by Category One and Category Three services.

PC interprets the 18,309 pricing policy to require local rates which are residually priced be reduced first to ensure that Category One services are maximizing contribution and Category Three services provide a contribution to joint and common costs. Under PC's interpretation, Category One services and Category Three services could not benefit from a rate reduction. This result is not reasonable nor logical. SWB is facing increasing competition in its services other than basic. To follow PC's proposal and leave these other services at their current level might cause SWB to lose customers and, therefore, lower contribution. In the current telecommunications environment, reducing the rates for services other than local basic service may maintain contribution or increase contribution through stimulation, thus meeting the goals of 18,309.

Under the provisions of Section 392.361 SWB has proposed that nonbasic services be classified as transitionally competitive. For those services so classified by the the Commission, SWB will have pricing flexibility. The new regulatory framework will render certain aspects of the decision in Case No. 18,309 inapplicable. In addition, Category One and Category Three services have contributed to SWB's excess revenues and those customers utilizing those services should benefit from any reduction in SWB's revenue requirement.

Since there is little likelihood a reduction in basic local rates would increase the level of telephone penetration in SWB's territory and the rates now charged for basic local service are just and reasonable, the Commission determined it is reasonable to reduce other rates in this proceeding. Reductions in service connection charges, the COETIC and Touch-Tone are related to the provision of basic service and will benefit local customers. Reductions in toll rates will benefit residential as well as business customers through the overall reduction of telephone bills. Benefits from the revenue reduction ordered in this proceeding will flow to all SWB customers and the Commission has determined will be more beneficial to those customers than a reduction in local basic rates.

Q. Pricing Policy

MCI raised as an issue in this proceeding the pricing policies and principles which underlie rate design decisions of the Commission. MCI contends that only through a complete reevaluation of SWB's current pricing practices, cost studies and existing rate structure can the Commission determine what SWB's true costs are and whether certain services are subsidizing other services. MCI's focus is primarily on the ability of SWB to price service elements to the competitive disadvantage of dependent competitors. These competitors must take service from SWB and then compete with SWB's own services. To achieve what MCI considers the proper principles and policies for setting rates, MCI is proposing the Commission adopt policies and principles different from those established in Case No. 18,309. RE: Southwestern Bell Telephone Company, 21 Mo. P.S.C. (N.S.) 397 (1977).

MCI's position is that the Commission should unbundle all SWB services into basic network building blocks, and establish each building block as a separate tariffed offering. Then MCI proposes that the Commission require SWB to impute the proper rates for each network building block into its own cost of providing services. To determine the appropriate cost for each service, MCI proposes the Commission adopt Long Run Total Service Incremental Cost Analysis (LRTSICA) as the proper costing method. Long Run Total Service Incremental Cost Analysis is different from the Long Run Incremental Analysis (LRIA) approved in 18,309. LRTSICA calculates the change or increment in the total cost of a firm caused by producing all of a particular service measured over a period long enough that it includes both fixed and variable costs. LRIA only measures the cost of a small change in the amount produced. LRTSICA measures the costs of using the most efficient current technology in the most efficient way, regardless of what the embedded costs for the service are.

As pointed out by MCI, it has been 12 years since the pricing policies in 18,309 were adopted. Significant and substantial changes have occurred in the telecommunications industry over that period of time. The Commission recognizes that the policies in 18,309 have been used as a guideline but have not been strictly applied and that cost studies prepared by Staff and SWB over the 12 years have not always met the requirements of 18,309. No LRIA has been conducted on any SWB service since 1983. MCI's witness Cornell very methodically discussed how SWB cost studies do not meet the requirements of a LRIA as approved in 18,309.

The Commission recognizes that some of MCI's criticisms of SWB's cost studies are valid when viewed against the standards set out in 18,309. The Commission has accepted SWB cost studies which have not always been long run, forward looking or incremental. Thus, although the general principles of 18,309 have been followed, the Commission has not maintained strict adherence to 18,309 pricing policies and procedures. This, though, does not render the underlying principles of 18,309 invalid but merely indicates that the Commission has not required SWB be in strict compliance with 18,309 standards. The Commission still believes that 18,309 provides a basic guideline for pricing rates and will follow these guidelines until the provisions of the new regulatory framework of Chapter 392 are implemented.

In addition, the Commission has determined that requiring SWB to perform new cost studies for all of its services is beyond the scope of this case and not warranted. SWB's current rates are based upon cost studies accepted by this Commission in past cases. The Commission can see little benefit from ordering SWB to perform complete new cost studies as a result of this case, especially since questions of subsidies will be addressed in SWB's classification docket, TO-89-56. In that case the Commission has required SWB and other parties to determine the proper costing method and develop a Cost Allocation Manual (CAM) for allocating costs between transitionally competitive, competitive and noncompetitive services. Once the proper costing method is determined and the CAM is in place, then SWB can perform cost studies for the services it wishes to classify as transitionally competitive.

These procedures adopted by the Commission in TO-89-56 will implement the requirements of Section 392.400, R.S.Mo. (Supp. 1987). Section 392.400 prohibits subsidization of transitionally competitive services by noncompetitive services. MCI, as a party to TO-89-56, will have an opportunity to present its evidence concerning the proper costing method in that docket.

It is evident that the requirements of Section 392.400 will modify the pricing policies of 18,309, as will the pricing flexibility provisions of

Sections 392.500 and 392.510, R.S.Mo. (Supp. 1987). The Commission has determined that it would be duplicative and unduly burdensome to order new cost studies prior to the decisions concerning the costing method, CAM and pricing procedures which must be made in TO-89-56. As stated before, the Commission still considers 18,309 to provide the basic guidelines for pricing services until the new provisions of Chapter 392 are implemented.

Conclusions of Law

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

Southwestern Bell Telephone Company (SWB) is a public utility subject to the jurisdiction of this Commission pursuant to Chapters 386 and 392, R.S.Mo. (Supp. 1987). SWB is a telecommunications company which engages in the provision of local exchange telecommunications service in Missouri. The complaints filed by Commission Staff and the Office of Public Counsel, Cases No. TC-89-14 and TC-89-21, were filed pursuant to Section 392.240. Under that section the Commission has the authority to determine whether the rates charged by SWB are unjust and unreasonable and to set just and reasonable rates for service.

The Commission consolidated with the complaints Cases No. TO-89-10 and TO-89-29. The Commission has jurisdiction over the TeleFuture 2000 proposal in TO-89-10 since the proposal would have changed the way the Commission set rates for SWB. The Commission has jurisdiction over TO-89-29 since it has authority to set the rates for each individual service.

The Commission, in determining whether there should be a reduction in SWB's revenue requirement, may consider all facts which in its judgment have any bearing upon a proper determination of setting just and reasonable rates. The Commission has considered the evidence in these consolidated proceedings and has determined that SWB's revenue requirement should be reduced by $101,323,000. The Commission found that SWB should have the option of sharing a theoretical reserve deficiency. If SWB accepts the option, the revenue requirement reduction will be $95,518,000. The Commission has concluded, based upon the findings in this proceeding, that SWB's revenue requirement should be reduced by the amount set out above, depending upon SWB's acceptance of the amortization sharing option.

The Commission found, based upon requirements that the Commission consider all relevant factors before granting a rate increase, that it could not approve the CPI rate adjuster proposed as a part of TeleFuture 2000. Since the TeleFuture proposal was submitted as an entire interdependent package, the Commission concludes that the TeleFuture 2000 proposal will not be adopted.

The Commission has made findings regarding which rates should be reduced to reflect the revenue reduction found to be reasonable. The Commission concludes that SWB's rates, as reflected in this Report And Order, shall be reduced as described.

Based upon the revenue reduction found reasonable in this Report And Order, the Commission concludes that SWB shall implement revised tariffs for telephone service which reflect a decrease in its Missouri jurisdictional gross annual revenues of $101,323,000, if SWB does not accept the amortization sharing option, or $95,518,000 if SWB does accept the amortization sharing option, exclusive of license, occupation, franchise, gross receipts or other similar fees or taxes and in compliance with the rate design changes ordered herein.

It is, therefore,

ORDERED: 1. That Southwestern Bell Telephone Company shall file, for approval of the Commission, tariffs designed to implement the revenue reduction and rate design as described in this order.

ORDERED: 2. That the tariffs to be filed pursuant to this Report And Order shall be effective for service rendered on or after July 1, 1989.

ORDERED: 3. That Southwestern Bell Telephone Company shall inform the Commission on or before 5:00 p.m., June 22, 1989, if it will elect the amortization sharing option.

ORDERED: 4. That Exhibit 75HC, Exhibit 111, Exhibit 197HC, Exhibit 270HC, Exhibit 296 and Exhibit 297 are received into evidence.

ORDERED: 5. That Staff's motion to strike portions of Southwestern Bell Telephone Company's Initial Revenue Requirement Brief is hereby denied.

ORDERED: 6. That any objections not heretofore ruled upon are overruled and any outstanding motions are denied.

ORDERED: 7. That the depreciation rates attached to this order as Attachment A are approved for Southwestern Bell Telephone Company if Southwestern Bell Telephone Company accepts the amortization sharing plan. If Southwestern Bell Telephone Company does not accept the amortization sharing option, Staff shall file, for the Commission's approval, depreciation rates on or before June 29, 1989 which are updated for the Commission decision on Capital Deployment.

ORDERED: 8. That Southwestern Bell Telephone Company shall submit to the Commission its network modernization program developed after this order becomes effective.

ORDERED: 9. That this Report And Order shall become effective on the 1st day of July, 1989.

BY THE COMMISSION

(S E A L)

Harvey G. Hubbs
Secretary

Steinmeier, Chm., Mueller, Hendren and Fischer, CC., concur and certify compliance with the provisions of Section 536.080, R.S.Mo. 1986.

Rauch, C., did not participate in Part I, Revenue Requirement, Cases No. TC-89-14 and TC-89-21; concurs in Parts II and III, TeleFuture 2000, Case No. TO-89-10, and Rate Design, Case No. TO-89-29, and certifies compliance with the provisions of Section 536.080, R.S.Mo. 1986.

Dated at Jefferson City, Missouri, on this 20th day of June, 1989.

Glossary of Acronyms and Abbreviations*

AMI	SBC Asset Management, Inc.
AVIS	Ad/Vent Information Services, Inc.
CAM	Cost Allocation Manual
CAPM	capital asset pricing model
CCS7	Common Channel Signaling System No. 7
CF.1	Comptroller's Fix 1.0
CISW	complex inside wire
CCL	carrier common line
COE	Central Office Equipment
COETIC	Customer Owned Equipment Trouble Isolation Charge
COR	cost of removal
COS	cost of service
CPI	U.S. Consumer Price Index
CPIU	U.S. Consumer Price Index - Urban
CTG	Capital Tracking Group
CUCRIT	Capital Utilization Criteria
CWC	cash working capital
DCF	discounted cash flow
DH&S	Deloitte, Haskins & Sells
DID	direct inward dialing
DR	Data Request
EAS	extended area service
EUCL	end user common line
FAC	fuel adjustment clause

*Except, see pp. 2-3 for acronyms and abbreviations for parties to these cases

FCC	Federal Communications Commission
FX	foreign exchange
GAAP	Generally Accepted Accounting Principles
Grafx	Ad/Vent Grafx, Inc.
Hay	Hay Management Consultant Survey
HOK	Hellmuth, Obata and Kassabaum Inc.
IMTS	Improved Mobile Telephone Service
INLINE	INLINE/INLINE PLUS
ISW	inside wire
ITC	investment tax credit
IXC	interexchange carrier
LDMTS	Long Distance Message Telecommunications Service
LEC	local exchange company
LRIA	Long Run Incremental Analysis
LRTSICA	Long Run Total Service Incremental Cost Analysis
MOER	Management and Operations Effectiveness Report
MSC	maintenance of service charge
MTP	Management Transitional Program
MTS	message telecommunications service
NID	Network Interface Device
NOI	net operating income
NTS	non-traffic-sensitive
OBRA	outside the base rate area
OBC	One Bell Center
PBX	private branch exchange
POP	point of presence
PTC	primary toll carrier
RBOCs	Regional Bell Operating Companies

S&P	Standard & Poor's Corporation
SBC	Southwestern Bell Corporation
SC	secondary carrier
SFAS	Statement of Financial Accounting Standards
SIPP	Supplemental Income Protection Plan
SLELG	straight line equal life group
SLRL	straight line remaining life
SWB-Media	Southwestern Bell Media, Inc.
SWB-Mobile	Southwestern Bell Mobile Systems, Inc.
SWB-Pub	Southwestern Bell Publications, Inc.
SWB-Telcom	Southwestern Bell Telecommunications, Inc.
SWB-YP	Southwestern Bell Yellow Pages
TAN	Technician Access Network
TEAM	Team Effectiveness Award for Managers
TRA	Tax Reform Act
USOA	Uniform System of Accounts
WAL	WATS/800 Access Line
WASP	Wide Area Service Plan
WATS	wide area telecommunications service
18,309	Case No. 18,309, RE: Southwestern Bell Telephone Company, 21 Mo. P.S.C. (N.S.) 397 (1977)

COMPANY: SOUTHWESTERN BELL TEL. CO.

STATE: MISSOURI

($000)

	RATE CATEGORY DESCRIPTION	12/31/87 INVESTMENT	12/31/87 RESERVE	CURRENT RATE	CURRENT EXPENSE	PSC STAFF UPDATED RATES RATE	PSC STAFF UPDATED RATES EXPENSE	PSC STAFF UPDATED RATES CHANGE	AVG. REMAIN LIFE	PL / AYFR *	FNS * %	RES * %
	A	B	C	D	E=B*D*.01	F	G=B*F*.01	H=G-E	I	J	K	L=100(C/B)
212	BUILDINGS	446,544	82,822	2.6	11,610	2.5	11,265	(345)	30.7	47/32	4.0	18.55
221	COE - STEP-BY-STEP	48,665	27,567	13.7	6,667	14.3	6,941	274	3.6	1991.1	-8.0	56.65
221	COE - CROSSBAR	25,837	(12,275)	36.1	9,327	40.1	10,370	1,043	3.7	1991.3	-1.0	-47.51
221	COE - OPERATOR SYSTEMS	8,156	340	0.0	0	21.6	1,762	1,762	N/A	NA	N/A	4.17
221	COE - CIRCUIT - OTHER	519,671	165,318	8.4	43,652	8.5	44,295	643	8.0	13.5	0.0	31.81
221	COE - CIRCUIT - DDS	20,490	7,757	12.2	2,500	11.8	2,409	(91)	5.2	9.5	1.0	37.86
221	COE - RADIO	54,934	14,993	5.9	3,241	6.2	3,432	191	12.6	18.0	-6.0	27.29
221	COE - ELECTRONIC ANALOG	408,210	167,047	5.3	21,635	5.3	21,597	(38)	10.6	18.0	3.0	40.92
221	COE - ELECTRONIC DIGITAL	122,232	11,477	7.1	8,678	6.7	8,205	(473)	13.2	20.0	2.0	9.39
231	STA APP-TTYP,TEL & MISC	991	287	15.3	152	13.8	137	(15)	5.3	3.3/6.9	-2.0	28.95
234	LARGE PBX - OTHER	26,770	23,745	0.0	0	3.2	868	868	4.1	5.9	-2.0	88.70
234	LARGE PBX - DDS	655	638	10.8	71	3.5	23	(48)	1.3	2.8	-2.0	97.42
235	PUBLIC TELEPHONE	27,156	15,792	9.0	2,444	8.5	2,319	(125)	4.9	9.2	0.0	58.15
241	POLE LINES	59,126	36,010	6.1	3,607	6.0	3,544	(63)	15.7	26.0	-55.0	60.90
242	AER. CABLE - EXCHANGE	189,063	83,774	4.6	8,697	4.6	8,650	(47)	17.2	28.0	-23.0	44.31
242	AER. CABLE - TOLL	1,298	941	4.1	53	3.7	48	(5)	9.4	13.0	-7.0	72.50
242	U/G. CABLE - EXCHANGE	226,225	74,467	4.2	9,501	4.1	9,273	(228)	21.0	34.0	-19.0	32.92
242	U/G. CABLE - TOLL	13,996	3,455	4.8	672	4.8	672	0	13.4	22.0	11.0	24.69
242	BURIED CABLE - EXCHANGE	634,625	186,351	5.0	31,731	5.0	31,590	(141)	16.2	25.0	-10.0	29.36
242	BURIED CABLE - TOLL	60,678	25,712	4.1	2,488	4.3	2,603	115	13.9	24.0	-2.0	42.37
242	SUBMARINE CABLE	392	66	5.0	20	6.7	26	6	13.1	22.0	-5.0	16.76
243	AERIAL WIRE - EXCH	3,223	4,023	10.5	338	10.3	334	(4)	6.3	16/12	-90.0	124.80
244	UNDERGROUND CONDUIT	128,148	29,288	1.7	2,179	1.7	2,148	(31)	49.0	65.0	-5.0	22.86
261	FURNITURE & MECHANICAL	58,639	8,607	7.0	4,105	6.4	3,743	(362)	11.8	26/10	10.0	14.68
261	COMPUTERS & AMA	179,741	61,430	15.1	27,141	13.7	24,633	(2,508)	4.0	7.0	11.0	34.18
262	OTHER COMM EQUIPMENT	93,313	55,747	5.2	4,852	6.7	6,294	1,442	3.3	6.0	18.0	59.74
264	VEHICLES - PASS & DEL CARS	27,966	12,663	11.5	3,216	11.8	3,291	75	3.8	7.9	10.0	45.28
264	VEHICLES - TRUCKS	1,353	1,039	8.3	112	7.2	98	(14)	2.1	8.5	8.0	76.79
264	OTHER WORK EQUIPMENT	25,225	6,707	8.1	2,043	7.8	1,961	(82)	8.8	14.0	5.0	26.59
	COMPOSITE TOTAL	3,413,325	1,095,780	6.2	210,732	6.2	212,531	1,799				32.10

* PL/AYFR = PROJECTED LIFE/AVERAGE YEAR OF FINAL RETIREMENT
FNS = FUTURE NET SALVAGE
RES = RESERVE IN PERCENT OF INVESTMENT