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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

CASE NO. TR-82-223

In the matter of the filing by
CONTINENTAL TELEPHONE COMPANY OF
MISSOURI of new intrastate rates,
tolls, and charges applicable to
intrastate telecommunication
services furnished within the
State of Missouri.

APPEARANCES: R. L. Hawkins, Jr., and W. R. England, III, Attorneys at
Law, P. O. Box 456, Jefferson City, Missouri 65102, for
Continental Telephone Company of Missouri.

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Missouri Public Interest Research Group.

James M. Fischer, Public Counsel, Martin J. Bregman, Richard W.
French, and Michael C. Pendergast, Assistants Public Counsel,
1014 Northeast Drive, Jefferson City, Missouri 65101, for the
Office of the Public Counsel and the Public.

A. Scott Cauger and Douglas M. Brooks, Assistants General Counsel,
P. O. Box 360, Jefferson City, Missouri 65102, for the Staff of the
Missouri Public Service Commission.

REPORT AND ORDER

On March 12, 1982, Continental Telephone Company of Missouri filed with the Commission revised tariff sheets reflecting increased rates for telephone service provided to customers in the Missouri service area of the Company. The tariff sheets contained a requested effective date of April 12, 1982, and were designed to increase annual revenues by approximately \$9 million.

On March 22, 1982, the Commission suspended the revised tariff sheets for 120 days beyond April 12, 1982, to August 10, 1982. On April 27, 1982, the Commission further suspended the revised tariff sheets for six months from August 10, 1982, to February 10, 1983, and set a schedule of proceedings.

The complete procedural history of the case is summarized in the Hearing Memorandum in this case, Joint Exhibit No. 1.

On October 18 through October 21, 1982, local hearings were held at

Branson, El Dorado Springs, Wentzville and Cuba, Missouri. Pursuant to Commission order, the Company sent notice of the public hearings to its customers in its September billing. The formal evidentiary hearings in this case were held in the Commission's hearing room in Jefferson City, Missouri, commencing on November 1, 1982 and concluding on November 5, 1982.

A true-up hearing was held in the Commission's hearing room in Jefferson City on December 30, 1982, pursuant to the Commission's order directing true-up audit issued December 2, 1982.

Subsequent to the presentation of evidence in this matter a briefing schedule was established. Initial briefs were filed by the Company, the Staff and the Public Counsel. Reply briefs were filed on behalf of the Company, the Staff and the Public Counsel.

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:

I. The Company.

Continental Telephone Company of Missouri (hereinafter the Company or CTM) is a telephone corporation as defined in Chapters 386 and 392, RSMo 1978, with its principal office located at Wentzville, Missouri. It is a wholly-owned subsidiary of Continental Telecom, Inc. (hereinafter CTI). The Company serves mostly rural areas in Missouri and operates 138 exchanges. The Company's Missouri intrastate operations are subject to the jurisdiction of this Commission.

II. Elements of Cost of Service.

The Company's authorized rates are generally based on its cost of service or revenue requirement. As elements of its revenue requirement, the Company is authorized to recover all of its reasonable and necessary operating expenses and in addition a reasonable rate of return on the value of its property used in public service. It is necessary, therefore, to establish the value of the Company's

property and to establish a reasonable rate of return to be applied to the value of its property or rate base which, when added to operating expenses results in the total revenue requirement of the Company. By calculating the Company's reasonable level of earnings, it is possible to determine the existence and extent of any deficiency between the present earnings and any revenue requirement to be allowed as additional revenue in any rate proceeding.

III. Test Year and True-up.

The purpose of using a test year is to construct a reasonably expected level of revenues, expenses and investment during the future period for which the rates to be determined herein will be in effect. Aspects of the test year operations may be adjusted upward or downward in order to arrive at a proper allowable level of all of the elements of the Company's operations.

All of the parties to this proceeding have agreed to utilize as a test year the 12-month period ending June 30, 1982, as updated for known and measurable changes through September 30, 1982. However, based upon the Commission's order directing a true-up audit, certain accounts have been trued-up through November 30, 1982. The results of the true-up audit were presented to the Commission at the true-up hearing on December 30, 1982. The record of that hearing and the results of the true-up audit constitute a portion of the record in this case.

IV. Rate Base.

A. Telephone Plant Under Construction.

Company proposes to include in its rate base short-term telephone plant under construction (TPUC) at the end of the test year, June 30, 1982. Short-term TPUC consists of construction projects to be completed in one year or less. Thus, these projects are scheduled for completion by June 30, 1983. As shown in Exhibit 35, "reconciliation between Staff true-up and Company case", test year TPUC at November 30, 1982, amounts to \$3,027,127.

In support of its position Company cites the FCC chart of accounts which prescribes that effective January 1, 1979, no interest during construction (IDC) is

to be accrued on projects having a duration of one year or less. Further, Company maintains that virtually all but \$13,105 of this plant will be placed in service by the operation-of-law date in this case. Therefore, the Company argues that TPUC will be serving current customers and fairness dictates the same customers should be required to pay for its corresponding costs.

Staff opposes the inclusion of TPUC in rate base and proposes to capitalize IDC from January 1, 1979 to the end of the known and measurable period. Public Counsel supports Staff. Staff believes that TPUC is the same as construction work in progress and therefore should not be included in rate base until it is used and useful. Staff contends that the Company has more capacity than is needed by current ratepayers and, therefore, the ratepayers are paying a return on plant costs in excess of plant necessary to serve them. Finally, Staff argues that the inclusion of TPUC would be improper because such inclusion would result in a mismatch of revenues, expenses and investment.

Having considered Staff's and the Company's arguments, the Commission notes that it is not bound by the FCC's system of accounts, nor is it convinced that excess capacity should determine the inclusion of TPUC absent a showing of unreasonable excess capacity. Furthermore, the Commission is concerned with the possible mismatch of revenues, expenses and investment that could result from the inclusion of TPUC. Company claims that it has adjusted all known and measurable revenues and expense items related to TPUC. It has recognized revenues associated with TPUC to eliminate multi-party service and it has increased depreciation expense resulting from plant under construction ultimately placed in service. In addition, Company asserts that associated toll revenues are included in its case since TPUC is included in rate base for toll settlement purposes. (See below Section IV, C. - toll revenues related to TPUC).

The Company's construction projects are aimed at customer growth, modernization and the provision of additional services. It is reasonable to assume that these projects are likely to result in reduced expenses and increased revenues.

The Company has not attempted to quantify revenues associated with customer growth and new services or expenses associated with modernization.

As a result of the true-up audit all TPUC booked at June 30, 1982, and placed in service as of November 30, 1982, will be included in rate base. Thus, all known and measurable items up to the latest possible time prior to the operation-of-law date are included in this case for ratemaking purposes. The Commission is of the opinion that to go beyond the true-up could result in a mismatch. The Commission believes that the matching of revenues, expenses and rate base is basic to proper regulation and, therefore, TPUC should be considered for inclusion in rate base only if the Commission is presented with forward looking data carefully designed to maintain a proper matching of revenues, expenses and plant. Such a presentation has not been submitted in this case. Thus, the Commission determines that short-term TPUC shall be excluded from rate base and that capitalization of IDC thereon shall be allowed.

B. Projected Construction.

The Company proposes to include in rate base committed construction in the amount of \$1,211,722 (Exhibit 35). Staff and Public Counsel oppose the inclusion of projected construction.

Projected construction represents the cost to complete projects classified in TPUC at June 30, 1982, along with their associated retirements, cost of removal and salvage. It also represents items that the Company has committed to construct and place in service by June of 1983.

Staff opposes the inclusion of projected construction for the same reasons that it opposes the inclusion of TPUC in rate base. In addition, Staff considers the inclusion of projected construction to be more offensive than TPUC as it is in Staff's view no different than budgeted construction and, hence, not a known and measurable amount.

The Commission finds it unnecessary to explore whether such projects are "committed" as characterized by the Company or "projected" as characterized by the

Staff since the Commission determines that such construction should be excluded from rate base for the same reasons that the Commission has excluded TPUC in this case.

C. Toll Revenues Related to Telephone Plant Under Construction.

Company contends that if Staff prevails on its proposal to exclude TPUC from Company's rate base, then the TPUC amount should not be used for purposes of computing the annual level of toll revenues for the purposes of this case. Company's position would increase Staff's revenue requirement by \$337,901.

The Company argues that since Staff has excluded TPUC from rate base for purposes of local service revenue requirement, it is inconsistent in its determination of toll revenues as it has included TPUC in the investment base for toll purposes. Company maintains that Staff's alleged inconsistent treatment results in a mismatching of revenues with rate base. The Company does not contend that the amount of jurisdictional toll revenue in Staff's case is incorrect, rather it asserts that TPUC should be excluded from investment base.

Staff contends that its method utilizes the Company's toll settlement agreement with Southwestern Bell (SWB) to determine actual toll service revenues which are factored into the gross revenue requirement. Staff asserts that since SWB has not been allowed TPUC for toll purposes, SWB toll rates do not include a return on TPUC. Therefore, none of the revenue received by Continental can be construed as a return on TPUC. Staff states that Bell still includes TPUC in the investment base to determine revenues paid to the independents in order to honor its settlement agreements and reduces the rate of return it pays to the connected companies on investment base that includes TPUC. Staff's witness admitted that he has no personal knowledge of how the settlement operates and that his knowledge of the method of settlement is based on conversations with the Company and the Staff.

It might be reasonable to assume that if SWB has not been allowed a return on TPUC for toll purpose then neither is the Company receiving toll revenues based on TPUC. The Commission, however, is unable to make such a finding, since in this proceeding it has been presented with little or no evidence as to the method of

settlement. Nevertheless, it is not clear from the evidence that investment base under the toll settlement is equivalent to rate base.

The Commission is of the opinion that the presence of TPUC in the investment base for purposes of toll settlement is not dispositive of this issue. Staff has simply included the amount of jurisdictional toll revenue that the Company receives under the settlement agreement. It is proper to include these revenues whatever the method of calculation.

The Commission finds and concludes that Staff has correctly included the amount of jurisdictional toll revenues that the Company receives for purposes of determining the revenue requirement in this case. The Commission finds, therefore, that the toll revenues included in the Staff's case should be accepted.

D. Cash Working Capital.

The Company did not include any cash working capital in its rate base. Staff computed a negative cash working capital of \$1,399,612 which was included in Staff's determination of rate base.

Staff performed a lead/lag study which compares revenue lag to the expense lag for the expenses incurred by the Company to provide service to the ratepayer on a day-to-day basis. The lead/lag study determines whether the source of cash working capital is the ratepayer or the shareholder. An overall positive cash working capital requirement reveals that funds to pay expenses are provided by the shareholder and an overall negative cash working capital reflects that such funds are provided by the ratepayer. Thus, in the case of a negative cash working capital requirement, the amount is deducted from rate base.

Company presents no evidence in support of its zero cash working capital requirement. Rather, it takes the position that a negative cash working capital is inappropriate in this case. Although the Company takes issue with Staff's cash working capital computation, it does not do so by challenging the validity of Staff's lead/lag study. Instead, its rebuttal witness prepared an exhibit (Exhibit 15, Schedule DM-6) designed to show that jurisdictional capitalization exceeds

jurisdictional rate base. The Company argues that such excess shows that negative cash working capital is incorrect since a negative cash working capital allowance implies that a portion of the Company's rate base has been financed with non-investor funds.

The Commission finds the Company's capitalization rate base comparison unconvincing. As Staff points out, the rate base shown in Company's Exhibit 15, Schedule DM-6 excludes TPUC. If TPUC were included in rate base, the rate base would exceed capitalization. Thus, even if the Company's argument were accepted, the inclusion of TPUC in rate base would be an indication that ratepayer supplied capital exists.

The Company's capitalization rate base comparison bears no relation to the calculation of cash working capital for ratemaking purposes. In fact, Company witness admits that the figure derived from the comparison does not generate a cash working capital figure. A cash working capital calculation is simply a method by which ratepayer supplied funds are identified. Since the Company has the use of those funds to pay expenses, the amount is deducted from rate base on the theory that it would be improper for the Company to earn a return on ratepayer supplied funds.

This Commission has consistently accepted the lead/lag methodology on the basis that it results in a reasonably precise cash working capital requirement. See Re: Kansas City Power & Light Company, Mo. P.S.C. Case No. ER-78-52, 28 PUR 398 (1979), and subsequent cases. In this case the Company admits that a properly prepared lead/lag study is a valid method of determining cash working capital. Since the Company has presented no evidence, challenging the validity of the Staff's lead/lag study and resulting cash working capital calculation, the Commission finds that Staff's cash working capital calculation should be accepted as appropriate.

E. Original Cost Rate Base.

Based upon the competent and substantial evidence in this case, and adjusting for the determinations reached on rate base issues above, the Commission finds and concludes that the Company's net original cost rate base is \$121,144,710.

V. Fair Value Rate Base.

The only evidence as to fair value is the Company's calculation. Therefore, the Company's fair value rate base of \$162,344,000 shall be used for purposes of this case.

VI. Operating Income.

A. Payroll.

The Company proposes to include in its cost of service an annual level of wage and related expense as of June 30, 1983, using June 30, 1982 employee levels. Staff's original case set payroll expenses at an amount that included wage levels for non-management employees as of September 30, 1982, and management employees as of January 1, 1983, using employee levels as of September 30, 1982. If Company prevails on this issue, Staff's revenue requirement based on the November 30th true-up would increase by \$394,479 as shown on Exhibit 35.

The difference between Staff and Company lies primarily in the cut-off periods used to determine the annual level of payroll expense of non-union hourly and union employees. The Company included wage rates which will become effective March, 1983 and June, 1983, respectively. These rates would then apply to the appropriate step on the progression schedule of each employee.

The Company contends that its wage expense is proper because it represents a known and measurable change of test year data occurring within one year of the test year. It maintains that it is proper for it to receive recognition of a known wage increase which the Company will incur as of March and June, 1983.

Staff, on the other hand, argues that its wage expense is proper since it is based on wages and salaries brought to a known and measurable level as of the operation-of-law date of February 10, 1983. Staff argues that Company's wage expense is not known and measurable and is so far beyond the operation-of-law date that it violates the concept of matching rate base expenses and revenues. Therefore, its adoption would be inequitable.

Although the Commission adheres to the test year and the concept of

matching revenues, expenses and rate base, it has allowed out of test year adjustments based on known and measurable changes. In addition, as Staff points out in its brief, the Commission has in certain cases permitted wage increases which occur beyond the test year and even beyond the operation-of-law date if the increase is known and measurable. Also the Commission considers whether it is more equitable to allow the additional expense than to disallow it because quantification of corresponding revenues is lacking.

In this case the Company has made no attempt to demonstrate the level of employees to be expected at June of 1983. In addition, the Company's wage expense purports to include step increases which could change if the mix of employees changes. Further, the Company was unable to quantify how much of its adjustment was attributable to the March increase and how much of the adjustment is attributable to the June increase. Based on these considerations, the Commission is of the opinion that the Company's adjustment does not constitute a known and measurable change.

Further, the Company seeks wage increases that will take place as late as June, 1983. Thus, the Company is proposing to recover these expenses prior to incurring them. The Company has made no attempt to pro-rate the increase to ameliorate this prospect of over-recovery. Thus, even if the Company's employee wage increases included reasonable wage levels and were, therefore, known and measurable, the Commission is of the opinion that to allow the wage increases in the manner proposed by the Company would be inequitable.

Having considered all of the foregoing, the Commission determines that Staff's wage expense takes into account known and measurable changes to the fullest extent possible and should be used for purposes of this case. Accordingly, the Commission finds that the Company's proposed wage expense should be disallowed.

B. Federal and State Income Taxes - Interest Expense Deduction.

Staff calculated the Company's interest expense deduction by multiplying jurisdictional rate base by the weighted embedded cost of debt. Staff's jurisdictional rate base includes rate base supported by job development investment

credit (JDIC).

The Company maintains that Staff's interest expense calculation is improper since Staff did not deduct the portion of rate base associated with JDIC. Company objects to Staff's treatment on two grounds: (1) the inclusion of JDIC is in effect assigning an interest cost to those credits where there is neither a contracted interest rate associated with JDIC, nor is there any deduction allowed for tax return purposes of interest associated with JDIC; (2) Staff's treatment reduces the Company's cost of service by more than a rateable portion of JDIC in violation of the Internal Revenue Code.

Staff argues that its method results in a reasonable and fair sharing of benefits associated with JDIC between the Company and the ratepayers. The interest cost Staff credits to JDIC by not taking JDIC supported plant out of rate base is no more fictitious than the return Company earns on equity not actually invested, since the Company under the Internal Revenue Code is required to earn a return on JDIC that is cost free to the Company. In addition, Staff contends that its method results in no violation of the Internal Revenue Code or its applicable regulations since Staff's treatment does not reduce cost of service by more than a ratable portion of the credit, does not reduce tax expense by all or a portion of the credit and does not treat JDIC as operating income in determining rate of return.

Having reviewed both the Company and the Staff's argument, the Commission is not convinced that an Internal Revenue Code violation will occur because of Staff's method. The Commission finds that Staff's calculation recognizes interest expense which accomplishes a proper matching of interest expense to the amount of interest the ratepayer is required to pay through the rate of return determination. This results in the sharing of benefits of JDIC between the Company and the ratepayers. Therefore, the Commission determines that Staff's interest expense calculation should be approved. The Commission's finding herein is consistent with the following cases: Re: Kansas City Power & Light Company, Case No. ER-80-48 (1980); Re: Mo. Public Service Company, Case No. GR-80-117 and ER-80-118 (1980);

Re: Southwestern Bell Telephone Company, Case No. TR-82-199 (1982). Union Electric vs. Federal Energy Regulatory Commission, 668 F.2d, 389 (8 Cir. 1981).

C. Unit Rule Expense Adjustment.

Staff disagrees with Company's use of the unit rule multiplier to adjust certain expenses which are not addressed separately in other adjustments to test year-end level operations.

In Company's original case it adjusted certain revenues and expenses by applying a 1.008 factor which is the ratio of main stations during the test year and main stations at the end of the test year.

To adjust miscellaneous revenues Staff used a ratio based upon the end of period customer level divided by the 13-month average customer level. With respect to miscellaneous revenue adjustment, Staff and Company arrived at almost identical results.

Staff has specifically adjusted certain expense items which the Company adjusted through the unit rule multiplier. These items include postage, employee benefits, and some charges for rent expense. Company does not take issue with these adjustments as it concedes that Staff's adjustments are superior to the Company's unit rule adjustments. Company desires that the unit rule multiplier be recalculated for operating expenses not specifically adjusted by Staff. If the Company prevails on this issue its revenue requirement would increase by \$34,721.

Staff takes the position that it has identified the large dollar amounts associated with increased main stations and any known and measurable changes. It sees no correlation between certain expenses and main stations and, therefore, opposes the unit rule adjustment.

Although the Company admits that there is no direct correlation between some expenses and main stations it did name two accounts that it contends are related to main stations, directory advertising and operator services. Both items are governed by contract and Company failed to bring these items to Staff's attention during the prehearing conference. After the matter was raised at the hearing, Staff

recommended that the Commission allow the Company an additional \$4,112 in revenue requirement related to directory advertising expense. The Company did not specify any adjustment that would be appropriate for operator services.

The Commission is of the opinion that the Company, which has proposed the unit rule adjustment, has the burden of proving its reasonableness. Rather than concentrate on the reasonableness of its adjustment, the Company simply accuses Staff of inconsistency in applying the unit rule to miscellaneous revenues, while not applying the rule to miscellaneous expenses. Staff maintains that miscellaneous revenues have a higher correlation to main stations than do expenses. The level of miscellaneous revenues does not appear to be a contested issue in this case. Thus, since the correlation between main stations and revenues has not been fully litigated in this case, the Commission is unable to determine that Staff's approach is inconsistent as Company suggests.

The Commission finds that the Company has not shown a correlation between those expenses which Staff has not adjusted and main stations. In fact, the Company admits that the correlation does not exist. Therefore, the Commission concludes that, since the Company cannot quantify increases to the expenses at issue herein to some known and measurable level, the Company's adjustment should be rejected.

VII. Capital Recovery.

Staff and the Company both performed remaining life depreciation analyses. At the time of the hearing the Company was in agreement with the revised depreciation rates proposed by the Staff for all accounts except the following: Account 231, Station Apparatus; Account 242.10, Aerial Cable; Account 242.30, Buried Cable; and Account 241, Pole Lines.

Subsequent to the hearing, but prior to the true-up hearing, the Commission by order issued December 29, 1982, approved the Stipulation and Agreement in Case No. EO-83-160, which established revised depreciation rates for Missouri telephone corporations which companies include Continental Telephone Company. Prior to the true-up hearing, the Company indicated by letter that it desired that the revised

depreciation rates for Accounts 231 and 234 approved by the Commission in Case No. TO-83-160 be utilized for purposes of this proceeding. The matter was addressed at the true-up hearing. Staff has no objection to the utilization of the revised depreciation rates for Accounts 231 and 234 for purposes of this case. No other parties have interposed an objection to the revised depreciation rates. Accordingly the Commission finds that the revised depreciation rates for Accounts 231 and 234 shall be utilized for purposes of this case. Therefore, Account 231, Station Apparatus, is no longer in issue. With respect to the remaining accounts the Company and Staff propose depreciation rates as follows:

	<u>Average Life</u>	<u>Remaining Life</u>	<u>Rate</u>
Account 241 Pole Lines			
Staff		19 year composite (7.16 years aerial wire) (24.15 years aerial cable)	4.8%
Company	19 years	13 years	7.0%
Account 242.1 Aerial Cable			
Staff	28 years	24.5 years	3.7%
Company	22 years	16.6 years	5.4%
Account 242.3 Buried Cable			
Staff	28 years	24 years	3.6%
Company	26 years	22 years	4.0%

In regard to Account 241, Pole Lines, the only difference between Company and Staff is the life of the aerial cable account used to compute the composite remaining life of aerial wire and aerial cable. Thus, this issue is limited to the calculation of average lives for Account 242.1, Aerial Cable and Account 242.3, Buried Cable.

To calculate depreciation rates for the two accounts, the Staff used the simulated plant balance method to arrive at average life. Staff's study used historical data for the years 1967 to 1981 through the use of seven-year rolling

bands. Staff examined successive additions and subtractions of a one-year balance of plant investment by account at the beginning and end of a seven-year time frame. Staff's method is an attempt to establish a trend in lives. The analysis showed a 30-year average life for aerial cable for the most recent seven-year span (1975 to 1981). The previous seven-year span (1974 to 1980) showed a 28-year average life. Staff chose a 28-year average life for the account as a conservative estimate of average life to be used for purposes of this case.

Staff's analysis of the Buried Cable Account 242.3 resulted in wide variations in the average lives ranging from 124 years to 14 years. Staff attributes these sporadic results to the effects of regrading and the Company's large investments of recent years. Since Staff's analysis did not appear to be indicative of any trend, Staff chose a 28-year life based on its judgment that buried cable should approach or exceed the life of aerial cable, otherwise it would not be economical to invest in buried cable.

The Company also used the simulated plant method together with engineering data and projections. However, it used a one-year balance (1981) to simulate curve disbursements and average life. Staff submits that the selection of average life under the simulated plant balance method cannot be derived from a one-year balance.

Company argues that for aerial cable Staff has used the high end of its study as the seven year bands range from 20 to 30 years. Further, the Company argues that the Staff has not considered air core cable in its buried cable calculation.

The use of the simulated plant balance is a method by which unknown retirement patterns of an account are matched with known retirement patterns of the Iowa curves. The Iowa curves produce simulated plant balances which are compared with actual balances. It is a trial and error method to establish the curve that produces the "best fit". Since the method produces trends and retirement patterns based on additions and retirements reflected in the balances it is highly unlikely that a one-year's balance could produce a curve fit that could produce any meaningful

result. Therefore, the Commission finds that the Company has not properly utilized the simulated plant method and its resulting average lives and depreciation rates are, therefore, unacceptable. In addition, although the Company claims it used projections and engineering data, it has not sufficiently enlightened the Commission as to its underlying assumptions that support these judgments.

The Commission is further of the opinion that Staff has performed an acceptable depreciation study in that it has used balances covering a greater period of time in order to establish trends and average life. With respect to aerial cable, Staff's average life is indicative of recent trends. With respect to buried cable, Staff's results were inconclusive. The Commission is of the opinion that Staff's choice of a 28-year average life is based on a reasonable judgment.

Based on the foregoing, the Commission finds and concludes that the Staff's depreciation rate shall be used for purposes of this case.

VIII. Rate of Return.

A. Capital Structure, Cost of Debt Capital and Preferred Stock.

All parties agree to the following capital structure and cost of debt and preferred stock as of June 30, 1982:

<u>Type of Capital</u>	<u>Capital Ratio</u>	<u>Cost Rate</u>	<u>Weighted Cost</u>
Short Term Debt	1.59%	15.30	.24
Long Term Debt	44.86%	7.835	3.51
Preferred Stock	4.60%	8.56	.39
Common Equity	48.95%	x	x

The Commission finds that the capital structure, cost of debt and preferred stock used by the parties in this case should be relied on. Therefore, the capital ratios, cost of debt capital and preferred stock as set forth above shall be used for purposes of this proceeding.

B. Return on Common Equity.

Since the Company's common stock is not publicly traded its required return on common equity must be calculated with reference to its parent CTI. The Company proposes a return on equity for CTI within a range of 17 to 18.5 percent. The Staff's recommended range for return on common equity lies between 15.15 and 16.25

percent.

The Company presented two witnesses on the rate of return issue. Company witness Moul based his recommendation on an equal weighting of the results he obtained from using the earnings price ratio (E/P), discounted cash flow (DCF) and the Capital Asset Pricing Model (CAPM).

Mr. Moul's analysis consisted of calculating E/P, DCF and CAPM for the following companies or groups of companies: (1) CTI; (2) AT&T; (3) four telephone holding companies; and (4) three independent operating companies. Having calculated DCF's and CAPM's for the four companies or groups, Mr. Moul equally weighted each calculation which produced a cost rate for common equity as follows: 16.6 percent for CTI, 15.7 for AT&T, 16 percent for the four holding companies, 17 percent for the telephone companies. After adjusting for issuance costs (the cost rate divided by 93 percent for non-Bell companies and 96 percent for AT&T) the required cost of equity was calculated to be 17.8 percent, 16.4 percent, 17.2 percent and 18.3 percent respectively. Mr. Moul then equally weighted the four cost rates for common equity capital which resulted in 17.4 percent for CTI. Finally, Mr. Moul determined that a 17.5 percent common equity cost was required for CTI due to the differences between the various companies compared. Witness Moul verified his results by performing a risk spread analysis which resulted in a 17.85 percent cost rate before issuance costs.

Company witness Alton employed a DCF which resulted in a return on common equity in a range of 17 to 18.2 percent. In his judgment a review of current and historical financial data applicable to the independent telephone industry, market capital attraction rates and the discounted cash flow analysis indicates a range of return requirement of 17 to 18.5 percent.

Staff Witness Shackelford used a comparable earnings approach and a DCF analysis to arrive at his recommended range of 15.15 to 16.25 percent. His comparable earnings approach considered market to book ratios, return on equity and common equity ratios of CTI and five holding companies; AT&T, CentTel, GTE,

Mid-Continent, Inc., and United. He did not consider the data for AT&T in developing his conclusions regarding an indicated return on equity for CTI because of AT&T's size. Based on his comparable earnings analysis, witness Shackelford concluded that a return on equity in the range to 15 to 16 percent was adequate for CTI. Witness Shackelford's DCF analysis resulted in a range of 15.3 to 16.5 percent. The recommended range of 15.15 percent to 16.25 percent results from an averaging of Mr. Schackelford's comparable earnings range with his DCF range.

As noted above, Company and Staff used DCF analyses. The DCF is a market related approach based on the concept of the current value of money. Although other methods provide insight and aid, the Commission has, for some time, indicated a preference for the DCF approach as an appropriate measure of required return on equity. This is because it is relatively simple to apply and measures investor expectations for a specific company. The formula is expressed as follows:

$$K = \frac{D1}{P0} + g$$

In the equation P_0 represents stock price, D_1 represents indicated dividend, g represents growth rate and K represents the required return. D over p is the dividend yield portion while g is the growth portion. The yield uses the current price and the indicated dividend and the growth portion uses the expected growth in the dividend. Since the DCF applies only to the cost of common equity obtained from retained earnings, adjustments must be made to recognize flotation costs associated with the sale of new shares.

Company witness Alton used historical averages of annual growth rates together with value line projections to determine the growth portion of the formula. Since the DCF is based on the theory of an infinite growth rate, his growth rate of 7 to 7.8 percent which is based on historic averages and short-term projection is not suitable. His dividend yield of 10 to 10.4 percent tends to be overstated since he has applied a growth rate of one-half of the expected annual growth rate to indicated dividends. This is unnecessary since growth is already accounted for in the g portion of the formula. The Commission is of the opinion that the dividend yield and

growth portions properly measure investor expectations when they are based on historical rather than projected data.

In addition, Mr. Moul's rationale for computing DCF for comparable groups, for averaging E/P's, DCF's and CAPM's for each group and then averaging all four groups to arrive at a common equity for CTI is not adequately explained. Further, Witness Moul improperly applies a 7 percent flotation cost to the total DCF return calculation as well as to the E/P and CAPM result.

Having considered the evidence presented, the Commission finds that Staff's DCF analysis of the appropriate return on equity is the most reasonable. It properly applies a long-run growth rate examining various five and ten year periods using average annual compound and trended growth rate. Its dividend yield is calculated using data from October, 1979 to September, 1982. The dividend yield range, 9 to 9.6 percent, encompasses the more current yields experienced by CTI in 1982 without considering the lower yields in 1981 and some of the higher yields in 1982. In addition, its flotation cost adjustment of 5 percent is properly applied to the yield portion of the DCF formula and is designed to cover the selling costs of an issue so that net proceeds from a market sale of common stock will be at least book value or above. Staff's comparative earnings analysis is based on reasonable assumptions and is acceptable to the Commission.

Based on the foregoing, the Commission finds that Staff's recommendation provides an appropriate range of return on common equity for CTI. Considering all of the evidence, the Commission finds that an appropriate return on equity for CTI is 15.7 percent.

C. Double Leverage.

Staff in an effort to recognize the financial leverage that exists between CTI and CTM, calculates a recommended return on equity for CTM in a range of 13.1 to 14.0 percent.

Staff contends that the CTI recommended range of return should not be the same as the recommended return for CTM because of the following reasons: The

Continental system's financial results show that the dollars of consolidated common equity are less than the composite book common equity of the subsidiaries. Staff attributes this difference to the fact that the parent's common equity does not represent the parent's total capital investment in the subsidiaries. Thus, the subsidiaries need to earn lower returns in order for the consolidated return to fall within the recommended range of the parent.

Staff calculated its recommended rate of return on equity for CIM in the following manner: First, Staff calculated a return on equity for CTI, the parent corporation. Second, Staff divided the net income of the consolidated corporation by the consolidated common equity to arrive at the return on equity actually earned by the consolidated corporation. Third, Staff then computed the additional income that would allow the consolidated entity to earn a return to Staff's recommended level. Finally, the additional income figure was then added to the subsidiaries' combined income and divided by a restated common equity amount for the combined subsidiaries, producing a required return on equity for the subsidiaries which would produce CTI's required return. These calculations were made using data from the years ending June 30, 1982, December 31, 1981, 1980 and 1979. Staff then averaged the results from the four periods to arrive at its recommended range of 13.1 to 14.0 percent. Staff's calculated returns compare favorably to returns on equity and equity ratios for Continental, GTE, Mid-Continent and United. They are also supported by data published by the United States Independent Telephone Association which represent composite data for over 700 telephone companies.

The Company is generally opposed to Staff's double leverage approach on the basis that the cost of capital should not be determined by the owner of the equity capital. The Company in particular, takes issue with Staff's method of applying double leverage alleging that Staff's witness does not apply the "traditional" double leverage approach. Company argues that the traditional approach is to apply the actual cost rates of the parent's capital structure to determine the subsidiaries' return on equity.

Company witness Moul in rebuttal produced a series of exhibits designed to show that Staff's calculations result in an unreasonably low cost rate for the parent's contributed capital. Witness Moul performed alternate double leverage calculations in the "traditional" manner eliminating retained earnings using both Staff and Company's recommended returns for CTI. Exhibit 22, Exhibit PRM-2, Schedules 2 and 3.

Company witness Alton also performed an alternate double leverage calculation by removing retained earnings from the parent's capital structure, computing the parent's overall cost of capital and applying the parent's overall cost of capital to the Company's common stock and capital surplus accounts. Finally, the required return on equity was applied to the subsidiaries' retained earnings account. Using this method the resulting rate of return was calculated to be 11.22 to 11.60 percent. Exhibit 23, Exhibit RA-1R, page 1.

The Company also opposes the Staff's double leverage method on the ground that in considering the consolidated equity and the earnings of CTI, Staff has improperly considered nonregulated entities, interstate toll service and JDIC, raising jurisdictional problems.

The record reflects that Staff's method was used because the parent keeps its books on an equity method of accounting as opposed to a cost method. Therefore, retained earnings of the parent reflect the undistributed earnings of the subsidiaries since acquisition, thereby overstating the parent's original equity investment. Staff was, therefore, unable to use the cost method since the parent's capital structure cannot be calculated on a cost basis in order to determine a cost of capital for the parent. Thus, the data was unavailable to the Staff for purposes of constructing a cost based double leverage calculation. The Commission notes that the Company's method does not cure this problem since the removal of retained earnings does not result in a cost based capital structure.

The Commission is of the opinion that it is proper to recognize the financial leverage that exists between CTI and CIM. The Commission is further of the

opinion that even though the use of a cost basis capital structure is preferable for purposes of reflecting financial leverage, Staff's method is appropriate since cost data was not available.

The Commission rejects the Company's arguments that Staff's method improperly recognizes income that is beyond the Commission's jurisdiction. The Staff has not made any expense or revenue adjustments that exceed the Commission's jurisdiction. Rather, it has simply recognized the relationship between the parent and the subsidiary in order to arrive at an investor required return in the situation where the subsidiary's equity is not market traded and where the subsidiary is wholly-owned by the parent.

Based on the foregoing, the Commission finds and concludes that it is appropriate for purposes of this case to determine the cost of equity to Continental Telecommunications, Inc., and then arrive at a return on equity for the subsidiary in the manner proposed by the Staff. Considering all of the evidence the Commission finds that an appropriate return on equity for Continental Telephone Company of Missouri is 13.6 percent resulting in a weighted cost of capital of 10.80 percent.

IX. Stipulated Issues.

Joint Exhibit 1, the Hearing Memorandum, states that the parties have reached an agreement on certain issues. The stipulated issues as contained in the Hearing Memorandum are set forth below. The Commission determines that the agreements should be accepted for purposes of this case.

A. Rate Design.

The parties have reached an agreement on all rate design issues in this case. Attached to the Hearing Memorandum and marked Exhibit A is a schedule which presents prioritized rate design packages. Local exchange access rates will not be increased unless the revenue requirement found to exist in this case exceeds \$3,149,000. Any revenue requirement above that amount will be raised by increasing local exchange access rates a uniform percentage increase in accordance with Staff's rate relationships. Revenue requirement up to that amount will be derived from the

packages, in sequence, starting with Package One and continuing through Package Five.

Rates for costed terminal equipment, under Package One, will be increased to a fully compensatory rate based upon Company cost studies and June 30, 1982 time units. This will generate additional revenues of \$1,051,000.

Under Package Two, rates for Extended Area Service will be increased by 23 percent. This will generate additional revenues of \$220,000.

Under Package Three, all elements of the service connection charge will be increased to the levels set forth in Exhibit B attached to the hearing memorandum. This will generate additional revenues of \$550,000.

Under Package Four, rates for non-costed items will be increased to 25 percent above current levels, and rates for costed terminal equipment will be increased to 15 percent over the rates set in Package One. These increases will generate additional revenues of \$985,000.

Under Package Five, rates for non-costed items will be set at 35 percent above current levels and rates for Extended Area Service will be increased to 46 percent above current rates. This will generate revenues, in addition to those raised in Package Four, of \$343,000.

Additionally, for one-party customers in the Indian Lake area of the Company's Cuba exchange a flat rate additive shall be set at \$1.20.

B. Quality of Service.

In its direct testimony Staff made several recommendations regarding specific areas of concern raised by its investigation of the quality of Company's service. All of these recommendations have been agreed to by Company in either their original or modified form, as specifically set forth below.

First, Company has agreed to comply with Staff's request for six monthly reports on certain service levels provided to the exchanges of Truxton, Timber, Foristell and Revere. Company also has agreed to file with the Commission a monthly progress report on its efforts to eliminate major faults found in certain cable pairs

identified in Staff's testimony. These latter reports shall continue until all such major faults are eliminated.

Second, Company has agreed to furnish to Staff cost estimate studies for the conversion of its eleven exchanges which have Operator Number Identification (ONI) to Automatic Number Identification (ANI) equipment, as well as the number of one-party customers as compared to total customers for the same exchanges, within thirty days of the effective date of the Report and Order in this case.

Third, Company has agreed to report on monthly basis, for six months, the percent of blockages customers encounter when placing 1 + DDD calls through the Strouger Automatic Toll Ticketer (SATT) equipment in the Wentzville toll center. If this data is not available at a centralized point within the toll center, then 200-300 test calls per month will be generated from the various exchanges using the SATT equipment and these results reported.

C. Depreciation.

The Company has agreed to comply with the following Staff recommendations, as modified, with all other parties raising no objection to these requirements:

(1) Retirement Schedule Reports

Company will provide reports showing any deviations from its retirement schedules, filed with this case, for Central Office Equipment, Buildings, and large PBX Accounts (Nos. 221.0, 212, 234.0 respectively) on an annual basis, beginning November 1, 1983, and on the first of November thereafter until such time as this Commission orders otherwise. Further, Company will provide detailed reasons explaining to what extent and why all retirement schedules were altered.

(2) Accounting for Station Connections

Company has agreed to meet with Staff on or before November 1, 1983, to outline procedures for establishing and maintaining proper accounting records for capitalizing inside station connection wiring

and apparatus. If no mutual understanding is reached as to the appropriate manner of accounting for this item, on or by January 2, 1984, all parties have reserved the right to present this item as a separate matter to the Commission for its determination.

With regard to item (1) above, after review and verification, Staff shall notify the Commission of compliance with the provisions hereinabove by filing a copy of each retirement schedule report and a memorandum of the procedures agreed upon for accounting for station connections in the case filed. With respect to item (2), in light of the Commission's Report and Order in Case No. TR-82-199, and the Federal Communications Commission's Memorandum Opinion and Order adopted December 22, 1982, in CC Docket No. 79-105, the parties should consider bringing this matter to the Commission's attention prior to the agreed upon dates.

(3) Property Records

Company has agreed to summarize mortality data by primary account and vintage year beginning with the year of earliest data, and thereafter, until such time as the Commission orders otherwise. Company has agreed to complete the task of bringing mortality data up-to-date by the end of 1984, unless ordered otherwise by the Commission.

D. Rate of Return Preferred Stock.

The parties have agreed that the Company will write-off \$13,979 of capital stock expense relating to retired preferred stock to reflect the correct amount of capital stock outstanding as of June 30, 1982. The Company further has agreed in the future to charge off a portion of capital stock expense applicable to any preferred stock that is retired.

X. Revenue Requirement.

Based upon the determination of the Commission herein, Continental Telephone Company's total net operating income requirement is \$13,083,629. The net operating income available for purposes of this proceeding is \$10,747,308, leaving a net operating income deficiency of \$2,336,321. After applying a factor for income

tax, and adding the amount related to revised depreciation rates for Accounts 231 and 234, Continental Telephone Company's gross revenue deficiency in this proceeding is found to be \$5,385,640. Applying the net operating income requirement of \$13,083,629 to the fair value rate base found reasonable in this case produces a fair value return thereon of 8.06 percent which the Commission finds to be reasonable.

Conclusions

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

Continental Telephone Company of Missouri is a public utility subject to the jurisdiction of this Commission pursuant to Chapters 386 and 392, RSMo 1978. The tariffs filed by the Company, which are the subject matter of this proceeding, were suspended pursuant to authority vested in this Commission by Section 392.230, RSMo 1978. The burden of proof to demonstrate that the proposed increased rates are just and reasonable is upon the Company.

The Commission, after notice and hearing, may order a change in any rate, charge or rental, and it may determine and prescribe the lawful rate, charge or rental, or regulations or practices affecting said rate, charge or rental thereafter to be observed. Section 392.230, RSMo 1978.

The Commission may consider all facts which, in its judgment, have any bearing upon a proper determination of the price to be charged with due regard, among other things, to a reasonable average return upon the value of the property actually used in the public service, and to the necessity of making reservation out of income for surplus and contingencies. Section 392.240, RSMo 1978.

When a public utility's existing rates and charges for telephone service are found to be insufficient to yield reasonable compensation for the service rendered, the Commission shall authorize revisions to the Company's applicable tariffs which will yield an appropriate fair return on the Company's property. The resulting rate shall be fair, just and reasonable and sufficient and shall not be unduly discriminatory or unduly preferential. When tariffs filed by a public utility

are designed to produce revenues in excess of those found to be just and reasonable, said tariffs should not be allowed to become effective as requested.

Based upon the Commission's findings herein, the tariffs filed by CTM in Case No. TR-82-223 should be disallowed, and the Company should be authorized to file revised tariffs in conformance with the findings of this Report and Order.

All objections not previously and specifically ruled upon in this matter are hereby overruled and all motions not previously and specifically ruled upon are hereby denied. All exhibits offered into evidence which have not been previously and specifically ruled upon are hereby received into evidence.

It is, therefore,

ORDERED: 1. That the revised tariffs filed by Continental Telephone Company of Missouri in Case No. TR-82-223 be, and the same are, hereby disapproved, and the Company is authorized to file in lieu thereof, for approval by this Commission, revised tariffs designed to increase gross annual revenues by \$5,385,640, exclusive of gross receipts and franchise taxes; and that said revised tariffs shall be in conformance with the rate design and other findings contained in this Report and Order.

ORDERED: 2. That the Company shall submit to the Staff on a timely basis, the reports designated in Section IX, B set forth above with respect to quality of service.

ORDERED: 3. That the Company shall provide reports showing any deviations from its retirement schedules, filed with this case, for central office equipment, buildings, and large PBX accounts on an annual basis, beginning November 1, 1983, and on the 1st of November thereafter until such time as this Commission orders otherwise. Said report shall provide detailed reasons explaining to what extent and why all retirement schedules are altered.

ORDERED: 4. That pursuant to the agreement of the parties the Company shall meet with the Staff on or before November 1, 1983, to outline procedures for establishing and maintaining proper accounting records for capitalizing inside

station connection wiring and apparatus, unless the parties bring the matter to the Commission's attention at an earlier date.

ORDERED: 5. That the Company shall summarize mortality data by primary account and vintage year beginning with the year of earliest data and thereafter and until such time as the Commission orders otherwise. The Company shall complete the task of bringing mortality data up to date by the end of 1984, unless otherwise ordered by the Commission.

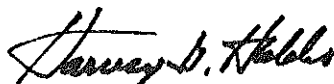
ORDERED: 6. That the Company shall write-off \$13,979 of capital stock expense relating to retired preferred stock to reflect the correct amount of capital stock outstanding as of June 30, 1982. In the future the Company shall charge-off a portion of capital stock expense applicable to any preferred stock that is retired.

ORDERED: 7. Pursuant to the Commission's interim order in this case, the Company is authorized to use "the Accelerated Cost Recovery System" for calculating depreciation for income tax deduction purposes and as further authorized to use a normalization method of accounting, is defined and prescribed in the Economic Recovery Tax Act of 1981, and as defined and prescribed in any rulings or regulations which might be promulgated to further explain or define the provisions of that Act.

ORDERED: 8. That the rates to be established through revised tariffs conforming to the Commission's findings and conclusions in this Report and Order may become effective for service rendered on and after the effective date of this Report and Order.

ORDERED: 9. That this Report and Order shall become effective on the 7th day of February, 1983.

BY THE COMMISSION



Harvey G. Hubbs
Secretary

(S E A L)

Fraas, Chm., McCartney, Dority and Shapleigh, CC., Concur and certify compliance with the provisions of Section 536.080, RSMo 1978.
Musgrave, C., Absent.

Dated at Jefferson City, Missouri,
this 26th day of January, 1983.