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BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

CASE NO. TR-81-208

In the matter of the filing by Southwestern Bell Telephone Company of new intrastate rates, tolls and charges applicable to intrastate telecommunication services furnished within the State of Missouri.

CASE NO. TO-78-46

In the matter of the usage-sensitive pricing study of Southwestern Bell Telephone Company.

CASE NO. TR-82-14

In the matter of Southwestern Bell Telephone Company for authority to file tariffs to establish dual element service connection charges.

APPEARANCES: Jack C. Lorenz, General Solicitor-Missouri, James E. Taylor, James S. Golden, Alfred G. Richter, Jr., Glen A. Glass, Cynthia A. Barton, Mark P. Royer, and Martin E. Grambow, Attorneys, Southwestern Bell Telephone Company, 100 North Tucker Boulevard, St. Louis, Missouri 63101, for Southwestern Bell Telephone Company.

Kent M. Ragsdale, General Counsel, Steven Dottheim and Thomas R. Parker, Deputies General Counsel, and William C. Harrelson and Mary Ann Garr, Assistants 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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Daniel S. Ochstein, Attorney at Law, and Freeman Bosley, Attorney at Law, Post Office Box 300, Summit Drive, Holts Summit, Missouri 65043, for Missouri Public Interest Research Group, Union Sarah Community Corporation, and Service Employees International Union-Joint Council 29.

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Robert J. Swift, Jr. and Ronald R. McMillin, Attorneys at Law, Carson, Monaco, Coil, Riley and McMillin, P.C., 211 East Capitol Avenue, Post Office Box 235, Jefferson City, Missouri 65102, for Missouri Farm Bureau Federation.

Dale E. Sporleder, Vice President-General Counsel, 11 Eleventh Avenue, Grinnell, Iowa 50112, for General Telephone Company of the Midwest.

REPORT AND ORDER

Procedural History

Company's Rate Request, Suspension of Tariffs and Scheduling of Proceedings

On January 9, 1981, Southwestern Bell Telephone Company (hereinafter referred to as "SWB" or "Company") filed with this Commission revised tariffs reflecting increased rates for telecommunications services provided to customers in the Missouri service area of the Company. Said revised tariffs bear a requested effective date of February 9, 1981, and are designed to increase the Company's jurisdictional gross annual revenues by approximately $129,544,000. By order dated February 2, 1981, the Commission suspended said revised tariffs for a period of 120 days beyond the requested effective date, until June 9, 1981, unless otherwise ordered. By order dated February 26, 1981, the Commission further suspended said revised tariffs for an additional period of six months, until December 9, 1981, unless otherwise ordered. Said order also established a schedule of proceedings, including a prehearing conference to be conducted from August 10 through August 21, 1981, and a formal hearing in Jefferson City, Missouri, commencing on August 24, 1981, and continuing through September 11, 1981, as necessary.

By motion filed on April 17, 1981, the Office of the Public Counsel (Public Counsel) requested that the Commission suspend certain tariffs filed by SWB on April 9, 1981, regarding the provision of Local Measured Service (LMS). LMS is offered by the Company in certain of its Missouri exchanges on an experimental basis. At the time of the filing of the motion by the Public Counsel, the Company had authority to provide LMS on such a basis only until June 2, 1981. The LMS tariffs filed by SWB on April 9, 1981, would authorize the provision of LMS on a permanent basis. Additionally, the Company, in its filing in Case No. TR-81-208, was seeking increases in rates for LMS. In addition to requesting that the Commission suspend the LMS tariffs filed on April 9, 1981, Public Counsel sought consolidation of the issue regarding permanent versus experimental status for LMS in Case No. TO-78-46 with the Company's pending general rate proceeding, Case No. TR-81-208. By motion filed on April 23, 1981, the Company requested that the Commission deny Public Counsel's motion for the suspension of the April 9, 1981, LMS tariffs and the consolidation of Case Nos. TO-78-46 and TR-81-208. By order dated May 14, 1981, the Commission consolidated for hearing Case No. TO-78-46 with Case No. TR-81-208, thus including the issue of the status of LMS within the Company's pending rate proceeding.

By motion filed July 7, 1981, the Staff of the Missouri Public Service Commission (Staff) requested that the Commission revise the schedule of proceedings in the consolidated Case Nos. TR-81-208 and TO-78-46. By order dated July 15, 1981, the Commission granted said motion, revising various deadlines for the filing of prepared testimony and exhibits and the scheduling of the prehearing conference and hearing, such that the prehearing conference was scheduled to commence on August 17, 1981, and continue through August 28, 1981, with the formal hearing to commence on August 31, 1981, and to continue through September 18, 1981, as necessary.

On July 31, 1981, SWB filed its "Amended Application" in the consolidated Case Nos. TR-81-208 and TO-78-46. By said Amended Application, the Company alleged the existence of an additional revenue deficiency of $52.6 million above and beyond the $129.5 million revenue deficiency alleged by the Company in its tariff filing of January 9, 1981, in Case No. TR-81-208. In conjunction with the filing of said Amended Application, the Company filed supplemental testimony alleged to support a finding of a total revenue deficiency of $182.1 million. The Company also submitted with its Amended Application tariff sheets (without requested effective dates) as an exhibit, for the purpose of suggesting to the Commission a rate design by which the total revenue deficiency alleged by the Company, $182.1 million, could be recovered. By order dated August 12, 1981, the Commission scheduled an oral argument regarding SWB's Amended Application, to commence upon the opening of the prehearing conference on August 17, 1981. During the course of the prehearing conference the Commission issued a ruling from the bench indicating that the Company's filing of its Amended Application did not, at that time, present an issue for Commission determination.

Parties to the Proceeding

In addition to the Company, which is the applicant herein, Staff and Public Counsel, the following entities were granted intervention in the instant proceeding: the Department of Defense and the General Services Administration of the United

States Government; the Office of Administration of the State of Missouri; St. Louis County, Missouri; the City of St. Louis, Missouri; the City of Cape Girardeau, Missouri; Mobile Radio Communications, Inc.; Missouri Retailers Association; Armco, Inc.; Missouri Hotel and Motel Association; Union Sarah Community Corporation; Service Employees International Union-Joint Council 29; Missouri Public Interest Research Group; (all said interventions having been granted by Commission order dated April 10, 1981); Missouri Farm Bureau Federation; the City of St. Joseph, Missouri; (interventions granted by order dated July 15, 1981); and the City of Trenton, Missouri, (intervention granted by order dated August 14, 1981). By Commission order dated April 10, 1981, General Telephone Company of the Midwest was granted permission, pursuant to Commission rule 4 CSR 240-2.110(17), to participate in the instant proceeding without intervention. In response to an SWB motion, the Commission, by order dated September 18, 1981, dismissed the following parties from the case: Missouri Retailers Association; Mobile Radio Communications, Inc.; City of Cape Girardeau, Missouri; and the City of St. Joseph, Missouri. By motion filed on July 30, 1981, the intervention of the Office of Administration of the State of Missouri was amended to reflect intervention by the State of Missouri through the Office of the Attorney General.

Notice to Customers and Local Public Hearings

By order dated June 11, 1981, the Commission scheduled local public hearings for the purpose of providing an opportunity to SWB customers to comment regarding the rate increase proposed in the instant proceeding. Said local public hearings were held in the City of St. Louis and in St. Louis County, Missouri, on July 20, 1981; in Cape Girardeau, Missouri, on July 21, 1981; in Springfield, Missouri, on July 23, 1981; in Sedalia, Missouri, on July 27, 1981; and in Kansas City, Missouri, on July 28, 1981. The proceedings had at said local public hearings are included in the record of the instant case. By letter dated June 12, 1981, the Company submitted to the Commission a proposed form of notice to customers regarding the rate increase being sought by the Company and the schedule of hearings in the instant case. Said proposed form of notice was modified by the Company on June 16, 1981. By order dated June 17, 1981, the Commission modified the Company's proposed form of notice to customers and directed the Company to cause such notice to be distributed to its customers, either through an imprint on a bill or through a separate notice by mail.

Other Procedural Matters

1. Discovery and Protective Orders

By motion filed on April 20, 1981, SWB requested that the Commission issue a protective order in the instant proceeding regarding discovery of materials alleged by the Company to be proprietary in nature. Also, the motion requested that the Commission establish deadlines for the conduct of the discovery process by the various parties in this proceeding. The only motion filed in response to SWB's request for a protective order and discovery cutoff dates was submitted by Armco, Inc. (Armco) on June 11, 1981. Armco took exception to a protective order provision suggested by the Company regarding access to proprietary information by expert witnesses of other parties. On June 16, 1981, the Commission issued a "Protective Order" which did not include the disputed provision regarding access of proprietary information by expert witnesses. Additionally, in said order, the Commission declined to establish discovery cutoff dates, but rather, informed the parties that objections to discovery requests would be ruled upon on an individual basis.

During the course of the hearing and upon motions submitted by the Company, the Commission issued certain evidentiary protective orders regarding information and data determined to be proprietary in nature. The Commission issued two types of evidentiary protective orders. The first type related to Exhibit 56 (Schedules 2, 6, 7, and 9, only), Exhibit 57, and Appendix A of Exhibit 94. The evidentiary protective order relating to these materials required that parties desiring access to these materials enter into a nondisclosure agreement, unless the parties were covered by a statutory nondisclosure provision. The second type of evidentiary protective order issued by the Commission related to Schedules 3 and 4 of Exhibit 152, the entirety of Exhibit 155, and the content of cross-examination related thereto which was conducted in an in camera portion of the hearing. The materials subject to this second type of evidentiary protective order, including the transcript from the in camera proceeding, are held under seal by the Commission.

2. Scope of Proceedings Issue

By motion filed on May 14, 1981, Public Counsel requested that the Commission initiate, within the context of the consolidated Case Nos. TR-81-208 and TO-78-46, an investigation of the rate structure of SWB for its various classes of intrastate services, or, in the alternative, that the Commission issue an order specifying that rate design evidence regarding services for which SWB has not proposed changes by its tariff filing in the instant case will not be deemed irrelevant or immaterial simply because the suspended tariffs of the Company do not directly affect those services, and that the Commission will consider all competent and substantial evidence regarding the rates and rate design of services not directly affected by the suspended tariffs submitted by the Company. By motion filed on May 27, 1981, SWB responded to the above-described motion filed by Public Counsel, requesting that the Commission deny Public Counsel's motion and including arguments in support of the requested denial. On June 10, 1981, Public Counsel filed a reply motion. By order dated July 1, 1981, the Commission held that the relationships between rates for the Company's various types of services constitute an integral part of determining "just and reasonable rates", and granted Public Counsel's motion by indicating to all parties to the proceeding that rate design evidence regarding services for which SWB has not proposed rate changes by its tariff filing in the instant proceeding will not be deemed irrelevant or immaterial solely because the subject tariffs of the Company do not directly affect such services.

3. Requested Consolidation of Dual Element Docket

On June 22, 1981, SWB filed certain revised tariffs by which the Company proposed to establish "dual element" service connection charges in lieu of its then presently effective "multi-element" service connection charges. By its tariff filing of January 9, 1981, in Case No. TR-81-208, SWB had proposed increases in the existing rates of its multi-element service connection charges. By order dated July 10, 1981, in docket no. TR-82-14, the Commission suspended the revised dual element tariffs for a period of 120 days beyond the July 22, 1981, requested effective date, until November 19, 1981. On July 20, 1981, SWB filed a motion requesting that the Commission consolidate for hearing Case No. TR-82-14 with the instant consolidated Case Nos. TR-81-208 and TO-78-46. On July 27, 1981, the Staff filed a motion in opposition to the Company's request for consolidation of Case No. TR-82-14 with Case Nos. TR-81-208 and TO-78-46, alleging, inter alia, that the Staff would not have sufficient time to review the Company's cost study supporting the dual element tariffs in order to submit testimony in regard thereto in the context of the hearing schedule established for Case Nos. TR-81-208 and TO-78-46. On July 31, 1981, SWB filed a response to the Staff's motion in opposition to the requested consolidation, wherein the Company renewed its request for the consolidation and suggested that the Staff and other parties be allowed additional time in which to file prepared testimony and exhibits regarding the Company's dual element service connection proposal. On August 3, 1981, Public Counsel suggested that the Commission either grant the consolidation proposed by the Company while providing additional time for the filing of testimony regarding the dual element service connection proposal, or that the Commission withhold consideration of the

Company's multi-element service connection proposal until a subsequent hearing at which both the multi-element and dual element proposals could be considered simultaneously. By order dated August 17, 1981, the Commission denied SWB's request for a consolidation of Case No. TR-82-14 with the consolidated Case Nos. TR-81-208 and TO-78-46, holding that since a significant question had been raised as to whether the Company's dual element service connection proposal could be subjected to adequate review during the course of the hearing dates already established in Case Nos. TR-81-208 and TO-78-46, the dual element tariffs should be considered under a separate docket at a hearing date to be determined in the future. On August 28, 1981, Public Counsel filed a motion requesting that the Commission reconsider its order denying the consolidation of the Company's dual element service connection proposal with Case Nos. TR-81-208 and TO-78-46. Also on August 28, 1981, a joint motion was filed on behalf of SWB and the Staff, suggesting a schedule of proceedings in the dual element docket, Case No. TR-82-14, with a hearing on October 19 through 21, 1981. The joint motion suggested that such a scheduling would provide adequate time for Staff review of the Company's dual element service connection proposal and would also allow for the possibility of a Commission determination regarding said proposal in conjunction with the Commission's decision in the Company's general rate proceeding, Case Nos. TR-81-208 and TO-78-46. During the course of the proceedings in said rate case, the Commission denied Public Counsel's motion for reconsideration, and by order dated September 18, 1981, the Commission adopted, with a minor revision, the schedule of proceedings proposed for Case No. TR-82-14 by the Company and the Staff in their joint motion. The hearing in Case No. TR-82-14 was held on October 19 through 21, 1981. SWB, the Staff, Public Counsel and MoPIRG participated in said hearing. Initial briefs in said case were filed by all of said participants, while reply briefs were submitted by SWB, the Staff and the Public Counsel. As will be discussed further in subsequent portions of this report and order, the Commission finds it appropriate to consider the Company's dual element service connection proposal in conjunction with this rate case, and, therefore, Case No. TR-82-14 is being consolidated with Case Nos. TR-81-208 and TO-78-46.

4. True-up Audit and Hearing

As part of the Hearing Memorandum produced by the parties at the prehearing conference in this case (Exhibits 2 and 3), the Company and the Staff agreed to a process of a true-up audit to be performed regarding various specified items of revenues and expenses for the actual 12-month period ending September 30, 1981. In the Hearing Memorandum the Company and Staff proposed that a hearing regarding the results of the Staff's true-up audit be presented to the Commission on November 12, 1981. By order dated September 18, 1981, the Commission scheduled a hearing regarding the results of the true-up audit for November 12, 1981, as proposed.

5. Statutory Requirement Regarding the Reading of the Record and Submission of Briefs

Upon the conclusion of the presentation of evidence in this matter, a briefing schedule was established calling for the submission of simultaneous initial briefs by the parties on or before October 22, 1981, and the submission of simultaneous reply briefs on or before November 2, 1981. Initial briefs were filed by the Company, the Staff, Public Counsel, Missouri Farm Bureau Federation, Missouri Public Interest Research Group, the State of Missouri, the Department of Defense and the General Services Administration of the United States Government, Armco, Inc., and Missouri Hotel and Motel Association. Reply briefs were filed by the Company, the Staff, Public Counsel, and the State of Missouri. The statutory provision of Section 536.080.2, R.S.Mo. 1978, regarding consideration of the record by the Commission, has not been waived by the parties.

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

Southwestern Bell Telephone Company (SWB or Company) is a public utility corporation duly organized and existing under the laws of the State of Missouri. SWB is a telephone corporation as defined in Chapters 386 and 392, R.S.Mo. 1978, with its headquarters and principal place of business located at 1010 Pine Street, St. Louis, Missouri. SWB is a wholly-owned subsidiary of American Telephone & Telegraph Company (AT&T) and is one of the Bell System's 23 operating companies. SWB provides telecommunications services throughout the states of Missouri, Kansas, Arkansas, Oklahoma and Texas. As of December 31, 1980, SWB had approximately 1,500,000 customers in the State of Missouri located in 167 exchanges, and the Company serves approximately 3,100,000 telephones. SWB'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 percentage of earnings to be applied to the value of its property or rate base which, when added to the 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. All of the aspects of the test year operations may be adjusted upward or downward to exclude unusual or unreasonable items, so as to arrive at a proper allowable level of all of the elements of the Company's operations.

All parties to this proceeding have agreed to the utilization of the twelve-month period ending April 30, 1981, as the test year, to be updated for known and measurable changes through September 30, 1981, through the operation of a true-up process. This process consists of a true-up audit conducted by Staff with the presentation of the results of said audit to the Commission at a true-up hearing. The methodology to be followed in the true-up audit was specified in the Hearing Memorandum (Exhibit 2), and the procedures outlined therein were adhered to. The results of the true-up audit were presented to the Commission at a hearing held on November 12, 1981, at the Commission's offices in Jefferson City, Missouri. The record of that hearing and the results of the true-up audit constitute a portion of the record in this case.

IV. Net Operating Income

A. Advertising

Three adjustments have been proposed to SWB's inclusion of test year advertising expenses in the calculation of the revenue requirement. Two of these adjustments are offered by the Staff, while the other is recommended by the Public Counsel.

1. Institutional Advertising

Staff has proposed that expenses incurred by the Company related to institutional advertising be excluded from the revenue requirement calculation.

Institutional advertising refers to that portion of advertising which is intended to stimulate good will for the Company with its customers. Institutional advertising can be contrasted with promotional advertising, which is intended to promote the sale of particular products or the use of particular services, and informational advertising, which is designed to provide information to customers regarding various aspects of the Company's services. Staff and SWB are in agreement as to the dollar amount associated with institutional advertising, and acceptance of the Staff's adjustment would result in an increase in SWB's net operating income for purposes of this proceeding of $47,000.

The Commission has previously held that expenses incurred for institutional advertising should not be included in the determination of rates. Re: Southwestern Bell Telephone Company, Case No. TR-79-213, et al. (March 1980). The reason for disallowance has been the lack of identification of any benefit to the ratepayer resulting from institutional advertising. No competent and substantial evidence has been presented in this case which would identify any such benefits. Therefore, the Commission is of the opinion that the Staff's adjustment is proper and should be adopted, thus increasing Company's net operating income for purposes of this proceeding by $47,000.

2. "Spillover" Adjustment

The Staff proposes an adjustment by which 30 percent of the test year expenditures incurred by SWB for television advertising in the St. Louis area would be disallowed. Acceptance of this adjustment would result in an increase in SWB's net operating income of $209,000. The basis for Staff's proposed spillover adjustment is that not all of the benefits from such advertising are received by Missouri ratepayers. The adjustment was calculated by taking the total dollar amount of television advertising expense for the St. Louis metropolitan area, and then applying to that dollar amount the percentage which Illinois residents constitute of the St. Louis metropolitan area viewing audience. This figure was determined to be approximately 30 percent. Staff agrees with SWB's contention that, even given the spillover effect, the use of television is the most efficient manner to conduct the type of advertising involved. Staff's contention is that SWB should be required to enter into some form of cost sharing arrangement with Illinois Bell so that the spillover costs are not borne by Missouri ratepayers. The Staff points out that the Company has entered into cost sharing arrangements regarding television advertising done in Joplin and Kansas City.

The spillover effects related to Joplin and Kansas City television advertising involve jurisdictions which are all included within SWB's operations. The Illinois spillover effect from SWB St. Louis area television advertising involves Illinois Bell. Three weeks prior to the hearing the Company contacted Illinois Bell regarding the possibility of entering into a cost sharing arrangement for the St. Louis spillover effect. However, Illinois Bell rejected the idea. SWB argues that its marketing objectives are not identical to those of Illinois Bell and, thus, implies that such arrangements are not as practical when separate operating companies are involved.

The Commission is of the opinion that Staff's proposed spillover adjustment should be rejected. The percentage utilized by the Staff in making the spillover calculation indicates that the majority of the St. Louis viewing audience is located in Missouri and, no competent evidence has been presented in this proceeding to demonstrate that a cost sharing arrangement is feasible between separate Bell operating companies. This result is proper especially in light of the fact that, even with the spillover effect, the television advertising in question constitutes the most economical form of advertising. However, the Commission notes that the possibility of such a cost sharing arrangement may exist, and the Company is directed to take every reasonable step to investigate such a possibility prior to its next general rate case.

3. Public Counsel's Proposed Ceiling on Advertising Expenses

Public Counsel proposes an adjustment to SWB's test year advertising expenses through which the level of said expenses exceeding a ceiling of .17 percent of operating revenues would be disallowed. Acceptance of the adjustment would result in an increase in SWB's net operating income for this case of $1,899,000.

It is Public Counsel's position that its adjustment is consistent with the Commission's determination on the advertising issue in the Company's last contested Missouri rate case, Case No. TR-79-213. Therein, the Commission held that a ceiling would be established for allowable SWB advertising expenses based upon the average relationship of advertising expenses to operating revenues of six Missouri independent telephone companies, unless evidence is submitted demonstrating that the advertising expenditures in question provide a benefit to ratepayers. Public Counsel's calculation of the proposed ceiling is consistent with the method specified by the Commission in Case No. TR-79-213 and is not disputed in this case.

SWB has presented considerable evidence in support of its position that its promotional advertising expenditures provide a benefit to ratepayers. Witness Schwob presented the results of an econometric analysis designed to quantitatively measure the cost effectiveness of the Company's long distance advertising. As a result of the analysis, Schwob concluded that $3.12 of revenues is generated for each dollar of residential long distance advertising expense, and that $1.94 in revenues is generated for each $1.00 of business long distance advertising expense. SWB also presented the testimony of Dr. Wilke regarding the function of advertising in the Company's provision of residential and business vertical services and also on the subject of certain direct-mail/direct-response advertising campaigns conducted by the Company. The evidence indicates that SWB's promotional advertising plays a positive role in the marketing of the Company's vertical services. It should also be noted that the provision of such services is an area in which the Company faces competition from nonregulated vendors.

Public Counsel contends that SWB has not demonstrated that expenses incurred in promotional advertising have a beneficial effect. This position is based generally on two arguments. First, Public Counsel contends that the intrastate toll and vertical service categories are actually being subsidized by revenues from the provision of local exchange service. Based upon this assumption, Public Counsel argues that no benefit is achieved by the Company's expenditures for promotional advertising of long distance and vertical services. Public Counsel's second line of argument involves specific attacks as to the validity of certain procedures utilized by Company witness Schwob in his econometric analysis of the effect of long distance advertising expenditures on revenues from long distance calling. As to the first point, Public Counsel's argument involves matters of proper cost allocation for rate design purposes and pricing decisions on individual products and services. The Commission finds that Public Counsel has not demonstrated that such matters are interrelated with the question of whether promotional advertising expenditures should be included for the purpose of calculating the Company's revenue requirement. whether promotional advertising expenditures should be included for the purpose of calculating the Company's revenue requirement. The Commission is of the opinion that SWB has demonstrated, to the extent reasonably calculable and by competent and substantial evidence, that its promotional advertising generates revenues in excess of related expenditures, and that such advertising is a necessary element in SWB's attempts to maintain and expand its market share with regard to services which are subject to substantial competition. Additionally, the Commission does not find Public Counsel's criticisms regarding certain aspects of the Company's econometric analysis of long distance demand to be persuasive. The Commission believes that the results of said study stand as competent and substantial evidence in support of SWB's position on promotional advertising.

Therefore, the Commission concludes that Public Counsel's proposed adjustment which would implement the previously described ceiling on SWB's advertising expenditures should be rejected.

B. License Contract Payments

The Staff proposes several adjustments to test year expenses of $15,600,000 incurred by SWB for services rendered to the Company by AT&T through the license contract. These adjustments include proposed disallowance of certain costs and capitalization of other costs. The Staff recommends disallowance of $2,311,253 of AT&T General Department expenses which the Staff alleges to be in the nature of "ownership costs", and proposes capitalization of $3,952,104 of expenses relating to Research and Systems Engineering work performed by Bell Telephone Laboratories (Bell Labs) and $2,431,334 in certain AT&T General Department costs. SWB opposes all of said proposed Staff adjustments and requests that the entirety of the $15,600,000 in license contract test year expenses be included in the calculation of the Company's revenue requirement.

The Staff also proposes a tax expense adjustment relating to those Research and Systems Engineering costs for which the Staff suggests capitalization treatment. This adjustment will be considered along with other tax-related issues in Section IV(D), infra.

The license contract is an agreement between AT&T and the Bell System operating telephone companies (BOCs) through which AT&T agrees to provide to the BOCs, including SWB, a wide range of services and privileges. The general areas of such services and privileges provided under the license contract are: the use of patents; the conduct of research; and the provision of advice and assistance.

1. Staff's Proposed Disallowance of Certain License Expenses

As noted above, the Staff recommends that $2,311,253 of SWB's test year license contract payments corresponding to certain AT&T General Department items be disallowed in this case. The AT&T General Department provides advice and assistance to the BOCs regarding various matters. AT&T owns a majority of the stock of 21 of the 23 BOCs and holds 100 percent ownership interest in 20 of said companies, including SWB. The Staff has specified certain costs contained in SWB's test year license contract expenses which the Staff characterizes as "ownership costs". The Staff contends that the costs so characterized result from AT&T's ownership function regarding the Bell System and its operating companies, as opposed to a service wherein a centralized and economical pool of resources can be provided. The Staff's position is that the BOCs constitute a substantial investment for the parent, AT&T, and that certain costs flowed through the license contract to the BOCs, including SWB, are related to AT&T's protection of this investment. By including such "ownership costs" in its billings through the license contract, the Staff alleges that AT&T is attempting to pass costs through to Missouri ratepayers which instead should be borne by AT&T investors.

The amounts under the license contract identified by the Staff as ownership costs can be subdivided into the following four categories: (1) below-the-line expenses; (2) costs incurred as a holding company; (3) antitrust costs; and (4) certain taxes.

The category of below-the-line expenses includes costs of AT&T contributions and lobbying activities. The Staff proposes disallowance of this item on the basis that costs related to such activities by SWB are recorded below the line on the Company's books, meaning that recovery of such items is not sought from Missouri ratepayers by SWB, and that it would be improper to permit AT&T to collect a portion of its cost for such activities from Missouri ratepayers through the license contract. SWB presents no argument in support of including these AT&T below-the-line expenses in the Company's revenue requirement in this case. The Commission concludes that these costs should not be borne by Missouri ratepayers and, therefore, these below-the-line expense items in the license contract should be disallowed.

Staff also suggests that a portion of certain costs under the license contract be disallowed on the basis that such expenses are of a nature normally incurred by a company owning securities of other corporations, but not obligated to perform services. The Staff characterizes these costs as "holding company costs". The Staff has identified certain corporate sector costs within the AT&T General Department which it deems to be associated with AT&T's holding company function. Staff recommends disallowance of 50 percent of the costs so identified on the basis of a recognition of the dual function of AT&T as both owner and service company. Staff's proposed disallowance of this portion of holding company costs under the license contract is consistent with Commission determinations in two previous SWB rate cases, Case No. 18,660 (December 1976) and Case No. TR-79-213 (March 1980). In Case No. 18,660 the Commission determined that certain costs could reasonably be attributed to the corporate function and, thus, disallowed; and in Case No. TR-79-213 the Commission approved the Staff's 50 percent disallowance of costs characterized as holding company costs. The Commission concludes that the Staff has identified particular categories of costs which are, in part, associated with AT&T's corporate function as an owner of subsidiary companies, and in the absence of any evidence indicating that a more precise allocation can be made within the accounts identified by Staff between holding company costs and costs related to AT&T's service function, the Commission is of the opinion that the 50 percent disallowance of such costs is a reasonable allocation.

The third category of ownership costs identified by the Staff is costs related to antitrust litigation involving AT&T and the Bell System. The basis for the Staff's 50 percent disallowance of such antitrust costs is that these costs arise out of AT&T's ownership of the BOCs and would not be incurred if AT&T were merely a service company. The Company contends that the Staff's proposed partial disallowance of antitrust costs is unreasonable in that, given the existence of such antitrust litigation, it is economically beneficial to avail itself of the centralized expertise of the parent company, AT&T. The Commission finds that the antitrust costs are the direct result of AT&T's ownership function of the BOCs and while it may be economically beneficial for SWB to avail itself of AT&T's expertise on such matters, the 50 percent disallowance proposed by Staff is a reasonable allocation of cost to be associated with AT&T's investment in the operating companies.

The final category of ownership costs for which the Staff proposes disallowance in this case is taxes. The amount disallowed includes New York State franchise taxes and the factor-up for federal income taxes on return on investment. The New York State franchise tax is a tax levied upon AT&T for the privilege of doing business and exercising a corporate franchise in the State of New York. Staff proposes allowance of only 2.4 percent of the New York State franchise tax expense included in test year license contract payments on the basis that said proportion is the extent of the franchise tax expense which can be linked to assets utilized in the provision of license contract services, and that the tax primarily relates to AT&T's ownership of New York Telephone Company. The Company contends that the franchise tax is not a function of AT&T's ownership of New York Telephone Company but, rather, that such ownership is merely the means by which the amount of tax is calculated. It is apparent that AT&T's total New York State franchise tax expense is not attributable to the provision of license contract services and that AT&T's ownership of New York Telephone Company is a substantial basis for the tax. Since SWB does not propose any alternative method for determining which portion of the New York State franchise tax can be linked to the provision of license contract services, the Commission concurs in the adjustment as proposed by Staff. The Staff also recommends disallowance of an amount associated with AT&T's factor-up for income taxes on return on investment. This involves the normalization of a tax benefit by AT&T which, if included in the calculation of the revenue requirement in this case, would permit AT&T to pass through to Missouri ratepayers via the license contract the effects of normalization of a tax timing difference, when the Commission has determined that flow through of such benefits is the preferred method for SWB in this case. See Section IV(D)1., infra. The Commission is of the opinion that since it has determined herein that flow through treatment should apply to SWB tax timing differences which are not restricted by the IRC, it would be inappropriate to allow AT&T to pass through to Missouri ratepayers the effects of normalization of this item through the license contract.

2. Staff's Proposed Capitalization of License Contract Costs

As noted previously, Staff recommends that the Commission require capitalization of $6,383,438 of test year expenses incurred by SWB through the license contract. The costs for which the Staff recommends capitalization treatment are composed of Research and Systems Engineering (R&SE) activities performed by Bell Telephone Laboratories (Bell Labs) and certain AT&T General Department activities performed under the license contract. Bell Labs is the research and development branch of the Bell System and is jointly owned by AT&T and Western Electric Company. Western Electric, in turn, is a wholly-owned subsidiary of AT&T and is the branch of the Bell System involved in the manufacture, purchase, repair and distribution of equipment. The work performed by Bell Labs is ostensibly separated into two components: Research and Systems Engineering (R&SE) activity which is funded through the license contract, and Specific Design and Development (SD&D) activities funded by Western Electric Company.

Staff argues that capitalization treatment is appropriate for the costs in issue on the basis that benefits related to these expenditures will be realized over a considerable period of years and, given that fact, it would be appropriate to defer recovery of these costs through capitalization treatment. Additionally, Staff contends that the R&SE costs and the General Department costs involved are attributable to the product development process and, thus, such costs should be capitalized as opposed to being treated as current expenses. An additional reason for capitalization treatment as to some of these costs offered by Staff is based upon the rationale that the Bell Lab and General Department activities related to these costs are analogous to activities conducted by SWB on a local level for which capitalization treatment is accorded by the Company.

The SD&D work performed by Bell Labs for Western Electric Company is admittedly connected with the intended development and introduction of specific products for utilization by the Bell System. SWB maintains that these SD&D product development activities conducted by Bell Labs on behalf of Western Electric Company are separable and distinct from Bell Labs' R&SE work which is funded through the license contract. Staff contends that a continuum exists between the SD&D and R&SE activities performed by Bell Labs, that there is an inseparable relationship between these categories of work and, as a result, that R&SE work is a component of the product development process of the Bell System. Along with the R&SE costs, Staff has recommended capitalization of certain AT&T General Department costs under the license contract which are related to product team and product life cycle management activities, and certain activities performed by AT&T as the central coordinator for Bell System product introduction, planning and management. Staff's adjustment also considers these General Department costs as being part of the product development process.

The Staff's central point in its argument regarding license contract costs characterized as product-related is that costs associated with the introduction of products should be recovered through the price of the product and, therefore, in a regulated setting such costs should be recovered over a period of years through capitalization, rather than being accorded expensing treatment and recovered currently.

SWB has presented various arguments in support of its position that R&SE costs under the license contract should be treated by this Commission as a current expense. SWB asserts that expensing of these types of costs is consistent with generally accepted accounting principles and that capitalization treatment is warranted only when specific benefits can be associated with expenditures in specific future periods and where ultimate future recovery of such costs is not in doubt. SWB also contends that the holding of this Commission in Re: Kansas City Power & Light Company, Case Nos. ER-81-42 and ER-80-48 (June 1981) (hereinafter referred to as "KCP&L report and order") regarding the issue of the proper ratemaking treatment of dues paid by Kansas City Power & Light Company to the Electric Power Research Institute (EPRI) requires that the R&SE costs at issue in the instant case be expensed rather than capitalized. The third major line of argument offered by the Company is in response to Staff's allegation of an interrelationship between R&SE work and SD&D activities. It is SWB's position that R&SE work is conducted without anticipating new or improved future products (as contrasted with SD&D activities on behalf of Western Electric), but that R&SE work has as its purposes research to assure the timely availability of knowledge and activities designed to find the most efficient way to utilize resources and to plan and operate the Bell System network.

In regard to the issue of whether the R&SE costs at issue should be considered as part of the product development process, the evidence supports a conclusion that the R&SE work performed by Bell Labs is not separable from the AT&T product development process. While the evidence indicates that all of the R&SE work performed by Bell Labs is not focused on the introduction of specific products in the same manner as the SD&D work conducted for Western Electric, the evidence presented, including the comparison of case authorizations under R&SE and SD&D activities, indicates a degree of interrelationship. Indeed, the evidence presented by Staff on this point indicates that AT&T recognizes the inseparability of the activities performed by Bell Labs in the timely introduction of improved products and technologies. In the context of the organization of the Bell System and specifically considering the interconnected relationship of Western Electric, Bell Labs and the Bell System operating telephone companies, the Commission concludes that the evidence presented supports a finding that the R&SE work conducted by Bell Labs and billed through the license contract cannot reasonably be considered separate and distinct from the Bell System's product development process.

Having determined that the R&SE costs at issue are inseparable from the product development process, the Commission concludes that capitalization treatment is proper for said costs and the test year AT&T General Department costs involving product team, product life cycle management and coordination of product introduction, planning and management activities. This holding is consistent with the Commission's determination of this same issue in SWB's most recent contested Missouri rate case, Case No. TR-79-213. In so holding the Commission rejects SWB's contention that the Commission's determination on the EPRI dues issue in the KCP&L report and order requires a rejection of the Staff's adjustment. The essential difference distinguishing the Commission's holding on the EPRI issue in the KCP&L report and order and the issue in question in this case is the inseparability of the research and development activities and the product development process that results from the integrated nature of the Bell System companies.

A portion of SWB's total test year license contract expenses for which the Staff proposes capitalization treatment relates to certain Systems Engineering activity and related AT&T General Department work involved in the centralized planning and design of telecommunications facilities and overall administration of Bell System operations, including construction management at the system level. It is the Staff's position that costs related to these activities are analogous to the engineering and administrative construction overhead costs which SWB incurs directly on a local level and which are capitalized by the Company. Thus, in addition to the product-related rationale described above, Staff offers the argument that these particular costs should be capitalized because they would be accorded such treatment if incurred by SWB. SWB opposes capitalization of these costs, contending that the license contract costs at issue are not analogous to costs capitalized by SWB on a local level. Company witness Riggert testified to the effect that the Staff was confusing "Systems Engineering" activity with work performed in the "engineering of systems". Riggert described work related to engineering a system as that work which the Company performs on a specific engineering project and which is analogous to what Staff witness Brosch refers to as capitalized administrative construction overhead. Riggert contrasted that type of activity with centralized and fundamental planning of the network which is performed by SWB on a local level and which, he contends, is analogous to the Systems Engineering work performed at Bell Labs (and related AT&T General Department costs). The Company's position on this matter is that activities performed by SWB on a local level in the centralized and fundamental planning of the network are presently expensed and that the Staff does not propose to capitalize those costs, and that there is no basis for capitalization treatment for costs associated with analogous activities provided by AT&T through the license contract. The Commission finds that no basis has been presented for separating these centralized planning and design and administrative costs from other R&SE costs for which capitalization treatment is recommended by Staff. Such activities clearly are related to and facilitate the introduction of new products and technologies into the Bell System. Thus, the Commission's determination on Staff's product-related argument should be controlling as to these costs. As a result of the Commission's determinations regarding Staff's proposed license contract expense adjustments, from the total SWB test year license contract expenses of $15,600,000, $2,311,253 should be disallowed and $6,383,438 should be accorded capitalization treatment. The revenue effect of these determinations is to increase SWB's net operating income by $4,776,000. As noted previously, the related issue of the Staff's proposed license contract tax deduction adjustment will be treated in Section IV(D)3., infra.

C. Capital Recovery

1. Expensing Station Connections

SWB seeks authorization from the Commission in this case to implement a plan for the phased-in expensing of the inside wire portion of station connection costs. Station connection costs include the costs of labor and material associated with installation, reinstallation and reconnection of station apparatus. Historically, the Commission has accorded capitalization treatment for ratemaking purposes of station connection costs. The expensing plan proposed herein by SWB is consistent with action authorized previously this year by the Federal Communications Commission (FCC).

The labor and material elements of station connections include all effort from the point of connection to the general distribution cable, up to and including the cost related to unpacking, connecting and testing the telephone apparatus. The station connection can be subdivided into two distinct parts: (1) the outside portion, consisting of the wire connecting the distribution cable to the particular building ("outside wire"), and (2) the inside portion, consisting of the wire connecting the telephone apparatus or plug-in terminal to the outside wire, the effort involved with connecting the telephone apparatus to the wiring and testing same, and the service order work (collectively referred to as "inside wire"). On the books of the Company the investment associated with station connections is included in Account 232. Costs of the station apparatus, which includes the instrument itself, are accounted for separately in Account 231. Station connections, therefore, as defined in Account 232, have no relationship to the cost of the instrument, other than the labor and material necessary for its installation.

By its report and order in docket no. 79-105 (adopted on November 6, 1980, and released on March 31, 1981) the FCC ordered a modification of the Uniform System of Accounts to accomplish a movement to the expensing of station connection costs. Previously, all station connection costs (both inside and outside wire) had been capitalized in Account 232, with recovery of such costs spread over the life of the service connection. Through its report and order the FCC determined: (a) that the "inside wire portion" of Account 232 should be expensed (that is, reflected on the company's books of account as an expense during the accounting period in which the cost is incurred) and that the outside portion of said account should continue to be capitalized; (b) that embedded investment related to inside wire contained in Account 232 should be amortized over a ten-year period; and (c) that the carriers affected by said report and order should move to the expensing of station connections-inside wire over a four-year phase-in period or, with state commission approval, could elect to institute a "flash-cut" under which immediate expensing of such costs would take place. The FCC directed that carriers affected by said report and order comply with the above-described revision of Account 232 no later than October 1, 1981, and permitted retroactive booking in accordance with said revision to January 1, 1981. SWB chose to book the expensing of station connections-inside wire retroactively to January 1, 1981, but the Company is presently also maintaining side-records reflecting capitalization of such costs.

In this case SWB seeks ratemaking treatment from this Commission consistent with the FCC's revision of Account 232 as described above, that is, the expensing of station connections-inside wire for ratemaking purposes through a four-year phase-in to full current expensing, and a ten-year amortization of embedded station connections-inside wire costs. Herein, SWB is proposing to recover the second year going level of expense under the four-year phase-in plan (in other words, 50 percent expensing), utilizing annualized test year end plant levels.

The initial Staff position with regard to this issue, as outlined in the Hearing Memorandum (Exhibit 2), was that the subject of expensing station connections-inside wire, and related issues of implementation and accounting, be addressed in a separate generic docket which would include participation, generally, by Missouri jurisdictional Class A and B telephone utilities. A Staff request for the establishment of such a docket was filed with the Commission on August 28, 1981. The Hearing Memorandum also indicates SWB's objection to postponing consideration of the expensing station connections issue beyond the operation of law date in the instant case. At the time that this issue was presented to the Commission during the hearings in this case, the Staff made no request that the Commission postpone consideration of the expensing station connections-inside wire issue, and the Staff presented its position in rebuttal, by which the Staff opposes implementation of the expensing plan presented by the Company and argues for the continued capitalization of station connections-inside wire costs. Alternatively, it is Staff's position that if a four-year phase-in plan for the expensing of station connections-inside wire is approved by the Commission, that only 25 percent of the expense level to be booked beginning October 1, 1981, be approved for ratemaking purposes.

In support of its request that the Commission recognize, for ratemaking purposes, the expensing station connections-inside wire plan described above, SWB suggests that such costs have been capitalized in the past based upon a desire by regulatory bodies to promote universal telephone service. The evidence indicates that approximately 95 percent of Missouri households presently have telephone service, and, as a result, the Company concludes that universal service has largely been realized in this state. SWB also contends that not all costs associated with station connections are suited for capitalization treatment, arguing that certain elements of such costs have no useful life beyond one customer and that the original cost of inside wire represents only a small portion of the amount capitalized in

Account 232. Company witness Peters testified that the investment contained in Account 232 has grown at a considerably faster rate than the rate of increase in total telephones, and that much of the increase contained in Account 232 is the result of the phenomenon known as "churn", (which refers, generally, to station connection activity resulting from customer movement), and from growth in the number of extension stations provided to customers. Thus, SWB's position is that any previous basis for the capitalizing of station connections-inside wire costs is no longer applicable.

Working from this assumption that the previously existing basis for the capitalization of station connections-inside wire costs no longer applies, and upon the assumption that the growth in Account 232 results, to a significant degree, from churn, the Company contends that the primary ratemaking purpose which should be pursued regarding station connections-inside wire costs is the assignment of costs to the "cost-causative" customer. This also is a primary rationale espoused by the FCC in its report and order in docket 79-105 in establishing its expensing plan. Both SWB in the instant case and the FCC in its report and order express the opinion that achievement of the goal of assigning service connections-inside wire costs to the cost-causative customer can be accomplished only by combining a compensatory rate design with a movement to the expensing of such station connection costs. Based on the position that expensing of such costs is a necessary component for the assignment of such costs to the cost-causer, the Company argues that the deferral of recovery by the Company of such costs through capitalization ratemaking treatment results in future ratepayers bearing the burden of costs incurred as a result of actions of current customers.

Various other arguments are cited by the Company in support of its request for expensing treatment for ratemaking purposes of station connections-inside wire costs. SWB is required by Commission rule 4 CSR 240-30.040(1) to maintain its books in accordance with the Uniform System of Accounts and, since the FCC's action has modified the Uniform System of Accounts to reflect the expensing of station connections-inside wire, continued capitalization treatment of these costs by the Commission for ratemaking purposes would necessitate the maintenance by the Company of side-records reflecting capitalization. SWB contends that the extent of side-records which would be involved is extensive and that the burden of maintaining such side-records is an additional reason in support of Commission approval of the Company's expensing proposal. Also, SWB notes that in a previous Commission case (Case No. TR-78-112) the Staff then supported a Company proposal which would have resulted in significant expensing of station connection costs, and that the Commission, in its report and order in said case (issued January 1979) deferred action on the Company's proposal pending conclusion of the FCC's proceedings on the subject of station connection costs, while expressing support for the concept of a movement toward expensing of such costs.

As an additional point, SWB asserts that, in the long run, implementation of the FCC expensing plan for ratemaking purposes will be beneficial to ratepayers in that the capitalization of an expenditure requires the additional cost elements of taxes and the provision of a return to the Company on the investment involved.

The Staff contends that the rationales advanced by SWB do not support implementation of the expensing plan for station connections-inside wire. Staff argues that the actual reason for the Bell System's movement toward the expensing of station connection costs is AT&T's desire, in the face of a continuous growth in the embedded investment contained in Account 232 for its operating companies, to improve the System's cash flow and to reduce its need to utilize external sources of funds. The Staff takes the position that the capitalization of station connections-inside wire costs is consistent with generally accepted accounting principles, arguing that said costs, taken in aggregate, are in the nature of a capital investment, in that the investment has a useful life extending beyond the immediate accounting period and produces a stream of revenues extending into future years. Staff also disputes SWB's position that the expensing of station connection costs is a necessary element for attainment of the goal of assigning the relevant costs to the cost-causative customer, and challenges the Company's assertion that, in the long run, the expensing of these costs will prove economically beneficial to ratepayers.

While various arguments have been put forth by both parties on each side of this issue, the Commission believes that the primary determinant should be the general ratemaking consideration of whether a particular utility expenditure should be accorded expensing versus capitalization treatment. The Commission is in agreement with the position stated by the Staff, that when an expenditure is in the nature of a capital investment, and thus results in a flow of revenues back to the Company over a period of years, such expenditure is more properly accorded capitalization treatment for ratemaking purposes. While certain elements of the costs involved in station connections-inside wire may have no useful life beyond one customer, the evidence also suggests that, on average, the aggregate investment constituting the inside wire portion of station connection costs has a useful life in excess of one year, and possibly in the range of three to four years. The Commission additionally agrees with Staff's analysis that the investment corresponding to station connections-inside wire should be viewed as an investment necessary for the flow of revenues back to the Company. Therefore, it is the Commission's conclusion that, from a ratemaking standpoint, station connections-inside wire costs are in the nature of a capital investment and, in the absence of the existence of some other overriding consideration, should be accorded capitalization treatment.

At this point SWB's argument that the expensing of station connections-inside wire is necessary in order to obtain the goal of assigning such cost to the cost-causative customer should be addressed. The Commission is of the opinion that the determination as to whether expensing versus capitalization is the proper treatment of an expenditure for ratemaking purposes is independent of considerations as to assignment of cost to the cost-causer. The proper basis for determining expensing versus capitalization treatment should center on the nature of the expenditure, as described in the preceding paragraph. Once that determination is made, assignment of the cost to the cost-causer, if that is the desired goal, is a matter of rate design and is separate and apart from expensing versus capitalization considerations. The Commission does not find the argument submitted by SWB in this case and the language in the FCC's report and order in docket 79-105 asserting an inseparable link between the expensing versus capitalization and rate design issues to be persuasive.

The Commission finds no evidence in the record, other than the assertion by witness Peters, which would support the proposition that the promotion of universal telephone service as a regulatory goal was the sole purpose behind the historic capitalization of station connection costs. As indicated above, the Commission finds that ratemaking considerations as to expensing versus capitalization treatment, in general, support continued capitalization of station connections-inside wire and, in that context, the question of whether the promotion of universal service may have, in some manner, entered into initial decisions to capitalize such costs is not relevant to the determination of the issue in this case.

The Commission acknowledges the concerns expressed by SWB as to the fact that failure of the Commission to authorize ratemaking treatment for station connections-inside wire consistent with the FCC plan will necessitate the maintenance by the Company of substantial side-records to reflect continued capitalization treatment. The imposition of such record keeping obligations upon the Company should not be and is not taken lightly by the Commission. However, the fact that authorization of a particular ratemaking treatment will impose such obligations should not be controlling as to the merits of the issue. When the Commission finds, in a particular instance, that ratemaking treatment is warranted which deviates from the Uniform System of Accounts, the requirement that side-records be kept is an inevitable consequence. The Commission's rules at 4 CSR 240-30.040(3) specifically contemplate such deviations, and to foreclose the possibility that the Commission may authorize ratemaking treatment at variance with the Uniform System of Accounts would be to acquiesce in the partial transfer of Missouri jurisdictional ratemaking authority to the FCC.

As to the question of whether the expensing, as opposed to capitalization, of station connections-inside wire costs would, in the long run, prove to be an economic benefit to ratepayers, the Commission is not convinced as to the validity of SWB's positive assertion on this matter, since there is no indication that the Company, in its analysis, has considered the present value of future dollars.

In the determination of any issue, the Commission is restricted to analyzing the evidence before it at a given time. In Case No. TR-78-112, the Commission was not presented with an analysis by its Staff which included a review from an accounting standpoint. Based upon the record presented in this case, it is the Commission's opinion that the question of expensing versus capitalization of station connections-inside wire costs is, first and foremost, a question of proper accounting treatment for ratemaking purposes. Thus, based upon all of the foregoing considerations, the Commission is of the opinion that the record in this case requires the rejection of SWB's proposal to implement the phased-in expensing of station connections-inside wire costs and such costs shall continue to be accorded capitalization treatment for ratemaking purposes by this Commission. The Company is directed to continue maintenance of side-records reflecting capitalization of such costs in a manner sufficient for review by the Staff of this Commission. The revenue effect of the Commission's determination on this issue is to increase the Company's net operating income by $5,476,000.

As noted previously, the Commission has pending before it a request by the Staff for the institution of a generic docket in Case No. TO-82-54 for the purpose of determining expensing versus capitalization questions associated with station connection costs, with participation contemplated by all Class A and Class B jurisdictional telephone utilities. The Commission wishes to express its intention to proceed with a generic investigation under said docket by granting Staff's motion. A schedule of proceedings for said investigation will be established by future order in Case No. TO-82-54. The Commission's determination of the station connections-inside wire issue in this case is based upon the evidence and arguments presently before it, and any further relevant evidence and arguments submitted in Case No. TO-82-54 will be fully considered.

2. Terminal Equipment Depreciation Represcription

In this case SWB proposes to recover the Missouri revenue requirement effect of a terminal equipment depreciation represcription taking place before the FCC. The represcription of these rates is based upon a new terminal equipment depreciation study and the resulting rates have been agreed to between the Staff, the Company, and the staff of the FCC. However, the FCC has not taken final action to prescribe these new terminal equipment depreciation rates and the Staff's position is that inclusion of the revenue requirement effect of such new rates would be premature prior to final FCC authorization of same. The revenue effect in this case of approval of the proposed new terminal equipment depreciation rates is $323,000 in net operating income.

In support of its request for inclusion of the new terminal equipment depreciation rates in this case, SWB argues that it is not aware of any instance wherein an agreement of this kind has ever been rejected or modified by the FCC, and that the Company is not aware of any reason why the proposed depreciation rates might be rejected or modified by the FCC in this instance. SWB contends that it is relatively certain that the FCC will issue a represcription order prior to or shortly after the operation of law date in this case (December 9, 1981) and that new terminal equipment depreciation rates will be in force during the period in which the instant report and order will be in effect.

While the Company, the Staff, and the staff of the FCC have agreed to proposed new terminal equipment depreciation rates, the fact that such rates are subject to rejection or modification by the FCC, regardless of the Company's assessment as to the likelihood of such rejection or modification, is sufficient reason for this Commission to withhold its own approval of said rates and the resulting revenue effect until such time as the FCC has acted. Therefore, the inclusion of the Missouri jurisdictional revenue effect of the proposed new terminal equipment depreciation rates is denied and, as a result, SWB's net operating income should be increased by $323,000.

3. Equal Life Group and Remaining Life Depreciation

As indicated by the Hearing Memorandum (Exhibit 2), at the commencement of the hearing SWB was proposing to implement the equal life group (ELG) and remaining life depreciation methodologies with a request to recover the second year going level of expense associated with implementation of said changes utilizing annualized test year end plant levels. The revenue effects associated with those changes were $2,125,000 in net operating income related to ELG depreciation and $5,683,000 in net operating income related to remaining life depreciation. The Staff's position at the commencement of the hearing, as indicated in the Hearing Memorandum, was that implementation of said depreciation methodologies in the instant case would be premature inasmuch as a generic docket had previously been established to investigate questions related to proposed implementation of these methodologies for all Class A and B jurisdictional telephone utilities (Case No. TO-82-3).

During the course of the hearings in this matter, SWB and the Staff entered into a Stipulation and Agreement (Exhibit 67) by which the Company agreed to withdraw consideration of the adoption of ELG and remaining life depreciation dependent upon an agreed-to schedule of proceedings in the separate docket, Case No. TO-82-3. As a result, the matter of SWB's proposed utilization of ELG and remaining life depreciation methodologies is not a contested issue in the instant case. Since the updated reconciliation resulting from the true-up process deletes the issue of ELG and remaining life depreciation methodologies and the corresponding revenue effects, the withdrawal of the issue from this case has no effect on the revenue requirement.

D. Income Taxes

1. Normalization Versus Flow Through of Income Taxes

SWB and Staff disagree as to the appropriate ratemaking treatment of certain tax timing differences. Specifically, SWB proposes normalization treatment of the tax timing differences related to the Company's vacation costs and cost of removal and salvage. Tax timing differences occur when a company is permitted to claim an expenditure as a current deduction for income tax purposes pursuant to the provisions of the Internal Revenue Code (IRC), but the associated expenditure is not fully recognized currently for ratemaking purposes. Pursuant to provisions of the IRC, the company is permitted to take as a current tax deduction its anticipated vacation costs for the following year even though its books reflect only the current year's vacation costs. The tax timing difference related to cost of removal and salvage is created by the inclusion of such costs in the depreciation rate for book purposes, while recognizing them when incurred for tax purposes. When tax timing differences are normalized the company involved receives currently the benefit of the related tax deduction, but is permitted, for ratemaking purposes, to spread the savings effect of the tax deduction over the life of the asset involved. The Staff proposes that the tax timing differences associated with following-year vacation costs and cost of removal and salvage be accorded flow through treatment for ratemaking purposes. When flow through treatment is accorded to tax timing differences, the accelerated tax benefit currently realized by the company involved is fully reflected currently as a decrease in the company's tax expense, rather than being spread over the life of the particular asset. The net operating income effect of these normalization versus flow through items is $1,714,000 for vacation costs and $3,652,000 for cost of removal and salvage. The Staff's case regarding cost of removal and salvage recognizes normalization of salvage related to SWB plant additions subsequent to December 31, 1980, and flow through of salvage related to SWB plant additions prior to December 31, 1980. This normalization treatment accorded by Staff to salvage related to post December 31, 1980, plant additions is the result of a recent revision to the IRC which requires normalization treatment of salvage for post December 31, 1980, plant additions in order for the accelerated tax benefit to be available.

SWB contends that normalization of such tax timing differences is consistent with generally accepted accounting principles in that such treatment matches the ultimate income tax effect with the related item of income or expense, and records both in the same accounting period, while flow through treatment reflects in income tax expense only the current period tax liability. SWB also takes the position that the deferred taxes which arise from normalization of tax timing differences are of substantial benefit to ratepayers. The Company's reasoning is that such deferred taxes constitute an important source of internally generated funds which are used to reduce the cost of financing the Company's construction program by partially displacing the necessity of the Company procuring additional capital from external sources at increasing costs. The Company also contends that the flowing through of benefits from tax timing differences does not further any legitimate regulatory purpose and, thus, constitutes an unnecessary restriction upon utility operations. The Company criticizes the Staff's flowing through of tax timing benefits where such treatment will not result in a loss of the tax benefit under the IRC as having no logical basis.

Staff asserts that the Company does not consistently follow the principle of matching tax effects with income or expense effects as espoused by the Company in support of its request for normalization treatment herein. According to the Staff, the Company's request for normalization of the tax timing benefits involved is based upon the desire to improve its cash flow rather than a concern for consistency with generally accepted accounting principles. Staff also disputes SWB's assertion that normalization treatment of tax timing differences benefits ratepayers, suggesting that unless such tax benefits are flowed through currently the customer may pay "phantom" taxes, with the Company receiving a permanent tax savings as long as expenses subject to normalization remain stable or increase, since the benefits of postponing present tax liabilities may more than offset previously deferred taxes that currently fall due.

The Commission has previously acknowledged the considerable difficulties inherent in attempting to determining whether, in the long run, the benefits to the ratepayer are greater using normalization or flow through ratemaking treatment of tax timing differences, and, as a result of such inevitable difficulties, the Commission has utilized a "cash flow test" for determining whether normalization treatment should be authorized for particular utilities. See Re: Missouri Public Service Company, Case No. 18,502E (1976). Accordingly, the Commission has held that normalization treatment should be authorized only upon a showing that the subject utility is experiencing significant cash flow problems. This cash flow test has been consistently applied by the Commission over recent years, including in SWB's most recent contested rate case in Missouri, and has been reaffirmed in several Commission cases decided in recent months. Re: Southwestern Bell Telephone Company, Case

No. TR-79-213, et al. (1979); Re: United Telephone Company, Case No. TR-80-235, et al. (1981); Re: St. Joseph Light & Power Company, Case No. ER-81-43, et al. (1981); and Re: The Gas Service Company, Case No. GR-81-155 (1981). No evidence has been presented by the Company in this case which would convince the Commission that normalization treatment is, in the long run, economically preferable to flow through from the ratepayer's standpoint. Thus, the Commission reaffirms its acceptance of the cash flow test, and said test should be applied in the instant case.

In analyzing the adequacy of a utility's cash flow for normalization versus flow through tax treatment determinations, the Commission utilized two basic indicators: first, the Company's internally generated funds as a percentage of construction expenditures, and secondly, the Company's interest coverage. SWB contests the validity of the internally generated funds as a percentage of construction expenditures criteria, arguing that such an analysis does not reveal whether the Company has limited its construction outlays as the result of cash flow restrictions. The Company also contends that its interest coverage levels are such that its AAA bond ratings are endangered, and that such a situation constitutes sufficient cause for the authorization of normalization tax treatment. SWB's indentures contain no interest coverage restrictions. SWB's post-tax interest coverage for the twelve-month period ending June 1981 was 2.79 percent, while the Company's internally generated funds as a percentage of construction expenditures was at a level of 66.57 percent for that same period. The Company states that its AAA bond rating is endangered unless its internally generated funds percentage is at an 80 percent level and its pretax interest coverage is in the 4 to 4.5 percent range. However, as pointed out by the Staff, both the Company's internally generated funds percentage and its interest coverages have been at levels significantly below those claimed as necessary by SWB for maintenance of its AAA bond rating, yet said rating has been historically maintained. Additionally, SWB's internally generated funds percentage and post-tax interest coverage levels were found to be 54.6 percent and 2.76 percent, respectively, during the Company's 1979 Missouri rate case, and such levels were determined by the Commission to be indicative of an adequate cash flow situation in the context of the normalization versus flow through issue. Case No. TR-79-213, et al. (1979), supra at p. 9.

The Commission is of the opinion that normalization tax treatment is warranted only when the utility requesting same can demonstrate significant cash flow difficulties. Although the internally generated funds percentage and interest coverage levels do not constitute the only possible indicators of a company's cash flow situation, the Commission is of the opinion that said indicators generally provide a sufficient basis upon which to identify cash flow problems of the magnitude deemed necessary to justify the granting of normalization tax treatment. Also, the Commission notes that the Company has not submitted any affirmative evidence upon which a finding could be made that its construction expenditures have been limited as a result of restricted cash flow. The evidence presented herein does not support a finding that SWB is experiencing cash flow difficulties on the order previously found to be necessary prior to granting of tax normalization treatment. Therefore, the Company is directed to utilize flow through treatment of the tax timing differences related to the issues herein contested, specifically, vacation costs and salvage and removal costs, and as a result the Company's net operating income for the purposes of this case should be increased by $5,366,000.

2. Interest Related to Telephone Plant Under Construction Construction (TPUC)

Interest related to debt incurred in connection with SWB's construction program (including both short and long term TPUC) is tax-deductible and, thus, the Company receives a current tax benefit for all such interest incurred within an accounting period. The question presented in this case pertains to the ratemaking treatment to be given the tax timing difference between the accrual of the tax benefit corresponding to this interest expense and the inclusion of TPUC (both short and long term) in the Company's rate base. The Staff advocates that this interest-related tax benefit be flowed through currently to ratepayers, while SWB seeks deferral of ratemaking recognition of this tax benefit until such time as the rate base item corresponding to the interest incurred is permitted in rate base. SWB is not requesting in this case that long term TPUC be included in rate base and, therefore, the Company's position is that ratemaking recognition of the tax benefit associated with interest related to long term TPUC should be deferred until those items of long term TPUC are eventually included in the Company's rate base. Concerning short term TPUC, the Company's stance is that ratemaking recognition of this interest-related tax benefit should be dependent upon the Commission's determination as to whether short term TPUC should be included in rate base in this case. If short term TPUC were to be included in rate base, SWB agrees that current recognition of the tax benefit would be appropriate. However, if short term TPUC is excluded from rate base, it is the Company's opinion that the ratemaking effect of the tax benefit resulting from interest incurred thereon should be deferred until there is inclusion of the short term TPUC in rate base. The Staff's position is that regardless of the Commission's determination as to the inclusion or exclusion of short term TPUC from rate base, the tax benefit associated with interest related to both short and long term TPUC should be recognized currently for ratemaking purposes. The total net operating income effect of the interest related to TPUC issue is $956,000, with $540,000 corresponding to long term TPUC interest and $416,000 to short term TPUC interest.

The discussion of the appropriate ratemaking treatment for short term TPUC is found in Section V(A), <u>infra</u>, of this report and order, wherein, for the purposes of this case, short term TPUC is excluded from rate base. As a result, the

Company's position as to the proper ratemaking treatment of the short term TPUC tax benefit is that such ratemaking recognition should be deferred until such time as the short term TPUC involved is placed in service and permitted in rate base.

The Company's contention on this issue is that current recognition of the interest-related tax benefit and deferred rate base inclusion of the corresponding TPUC is inconsistent in that it would confer the tax benefit upon "current ratepayers" while deferring the costs connected with the inclusion of plant in rate base to "future ratepayers". The Staff's position is that interest related to TPUC (both short and long term) is merely an additional normalization versus flow through question, in that a tax timing issue results from the Company's ability to take a current income tax deduction for an expense related to an expenditure for a capital asset, where the ratemaking recognition of such expenditure is reflected over a period of years. Staff, then, considers that the ratemaking treatment of interest related to TPUC should be governed by the Commission's choice of normalization versus flow through as the proper method of treating tax timing differences, rather than by the Commission's determination as to rate base treatment of TPUC.

A review of the briefs submitted by SWB and the Staff indicates that the "matching concept" is being utilized by said parties in different contexts with different meanings. SWB attacks the Staff for embracing a "matching concept" in its position on the proper rate base treatment of short term TPUC and abandoning this "matching concept" regarding the question of the tax timing treatment for the interest related thereto. As should be evident from a review of the Commission's decision herein regarding the appropriate rate base treatment for short term TPUC in Section V(A), <u>infra</u>, the relevance of a "matching concept" to that issue as determined by the Commission involves concerns as to the integrity of the test year as a basis for establishing rates. On the other hand, SWB's advocacy of a "matching concept" on the interest related to TPUC issue appears to be based more upon an argument that costs and benefits must be matched between "current" and "future" ratepayers. Thus, the Commission does not agree with Company's contention that the Staff's positions on these issues are inconsistent.

The Commission is of the opinion that the question of the appropriate ratemaking treatment to be accorded the tax timing treatment of interest related to TPUC is equivalent in nature to other normalization versus flow through issues. Inasmuch as the Commission has reaffirmed the use of its cash flow test in determining whether normalization or flow through treatment should be accorded to tax timing differences, and has further determined that SWB is not experiencing cash flow difficulties sufficient to warrant authorization of normalization treatment (see Section IV(D)1., supra) the benefit of the Company's tax deduction resulting from interest related to TPUC (both short and long term) should be flowed through currently to ratepayers. As a result of the Commission's determination on this issue the Company's proposed net operating income for ratemaking purposes should be increased by $956,000.

3. License Contract Tax Deduction

Staff has proposed an adjustment to the tax expense amount submitted by the Company in the instant case. The effect of the adjustment is to reduce the amount of the Company's tax expense for ratemaking purposes and, ultimately, increase the Company's net operating income by $2,037,000. Staff's adjustment relates to the ratemaking treatment to be accorded the tax deduction which is associated with the Research and Systems Engineering (R&SE) costs billed by AT&T to SWB through the license contract. As determined in Section IV(B)2., supra, the Commission has held in this case that such R&SE costs should be capitalized, rather than expensed as proposed by the Company. The Commission's decision in SWB's most recent contested Missouri rate proceeding, Case No. TR-79-213, also provided for capitalization treatment of such R&SE costs. Nevertheless, since the Commission decision in Case

No. TR-79-213 the Company has continued to record R&SE costs on its books as a current expense item. Pursuant to the provisions of the Internal Revenue Code the Company is entitled to take as a current tax deduction those research and development costs which it has incurred regardless of the manner in which such costs are reflected on the Company's books of account. The evidence indicates that SWB has, in fact, availed itself of this current tax deduction treatment of research and development expenses (herein, the R&SE license contract costs). The difference in positions between the Staff and SWB is that the Staff advocates that, for ratemaking purposes, the Company's tax expense be reduced to reflect the actual current tax deduction enjoyed by the Company, while SWB maintains that, for ratemaking purposes, the benefit from the tax deduction involved be spread over future years in a manner parallel to the capitalization treatment proposed by the Staff (and herein adopted by the Commission) for the R&SE costs, themselves.

The Staff's position essentially rests on the proposition that the provision of the Internal Revenue Code allowing a current tax deduction of these R&SE costs, for which the Commission has required capitalized ratemaking treatment, creates a tax timing difference. Thus it is the Staff's contention that this issue resolves itself into a question of normalization versus flow through of a benefit resulting from a tax timing difference. The resolution of this issue, then, would be governed by the Commission's general determination on the normalization versus flow through question. As determined in both subsections 1 and 2 above, the Commission has found flow through to be the appropriate ratemaking treatment of the benefits from tax timing differences which have been at issue in this case.

In opposition to the adjustment proposed by Staff, SWB expresses much concern regarding the total dollar amount reduction in revenue requirement which would be produced by a combination of the Staff recommendations regarding disallowance or capitalization of various amounts of the Company's test year license contract expenses and the tax expense adjustment proposed herein. First, as pointed out by Staff, the figures used in the Company's comparison are misleading in that they inappropriately compare test year license contract expenses, on the one hand, and Staff proposed license contract expense adjustments combined with the revenue requirement impact of the Staff's tax expense adjustment. Additionally, the Company's comparison does not distinguish between costs which the Staff recommends be disallowed and costs which the Staff argues should be capitalized rather than expensed. More importantly, the entire line of argument by the Company in which it makes this revenue requirement impact comparison avoids the merits of the issue. The Company does argue that if the R&SE costs were to be built into the price of products sold by Western Electric Company to SWB and the other operating telephone companies (which, Staff suggests, is the appropriate theoretical treatment of these R&SE costs), then the Company would no longer be entitled to a current tax deduction of those costs under the Internal Revenue Code. However, the relevancy of this fact to the determination of the instant issue is not apparent. The facts which the Commission finds relevant to the determination of this issue are: (1) that the R&SE costs are currently billed to SWB through the license contract and are the source of a current tax benefit of which SWB avails itself; and (2) that the adjustment proposed by Staff on this issue would result in the benefit from the current tax deduction being fully and currently recognized in the calculation of the Company's revenue requirement and, thus, flowed through to ratepayers. The Commission agrees with Staff that the license contract tax deduction issue should be treated consistently with the Commission's determination as to normalization versus flow through. As a result, Staff's adjustment is found to be proper and SWB's net operating income for the purposes of this case should be increased by $2,037,000.

E. Summary

Giving effect to all of the adjustments to net operating income found to be reasonable and proper, the Commission finds that SWB's annual net operating income, for the purposes of this proceeding, to be $128,263,000.

V. Rate Base

A. Telephone Plant Under Construction (TPUC)

SWB proposes that the Commission include in its calculation of the Company's rate base all end-of-test-year short term TPUC, which amounts to $19,436,000 in rate base. The Staff recommends that the Commission exclude short term TPUC from its calculation of the Company's rate base. Short term TPUC refers to telephone plant under construction which is designed to be completed and in service within one year.

SWB contends that the inclusion of short term TPUC in rate base would result in an appropriate distribution to customers of responsibility for support of the Company's construction program. It is the Company's position that its short term construction projects primarily benefit customers who are presently receiving service from SWB, while construction projects designed to be completed over periods greater than one year in duration primarily benefit future customers. Based upon this distinction, SWB argues that short term and long term TPUC should be given different rate base treatments, with short term TPUC included in rate base to earn a current return on investment and long term TPUC excluded from rate base until placed in service, but presently accorded capitalized IDC treatment. SWB also states that inclusion of short term TPUC in rate base would be consistent with the Uniform System of Accounts as modified by the Federal Communications Commission (FCC) and with that commission's ratemaking treatment of this issue.

In opposition to the Company's proposed inclusion of short term TPUC in rate base, Staff argues that such construction is not presently useful to ratepayers since, by definition, the plant involved is not yet completed and in service. Staff's position is that ratepayers should not be required to pay a return on plant until such time as a corresponding benefit is being provided. Also, Staff contends that various types of construction projects undertaken by SWB result either in increased revenues or in cost savings for the Company, or both, and that inclusion of short term TPUC in rate base without a corresponding offset to reflect such related revenue and expense effects would produce a distorted test year with an inflated rate base.

While plant does not provide a present benefit to customers until such time as it is placed in service, it is uncontested that the prospective plant included in the category of short term TPUC is designed to be placed in service either prior to or during the period in which the rates for service established by this report and order will be effective. While the Commission in past cases has consistently excluded short term TPUC from rate base, the Commission is of the opinion, based upon the fact that such short term construction is designed to be in service during the period in which the newly-prescribed rates will be in effect, that short term TPUC could properly be included in rate base if not for the danger that a distorted test year might result.

The Commission agrees with Staff's position as to the importance of maintaining, to the fullest extent possible, a matching of revenues, expenses, rate base and rate of return in order to produce a test year which is suitable for the purpose of forming the basis upon which rates of future applicability are to be established. Additionally, it would appear reasonable to assume that certain of the Company's construction projects included in the category of short term TPUC will have corresponding revenue-producing or cost-savings effects. In this context, the Commission concludes that it would be inappropriate to include short term TPUC in rate base without the presentation of an acceptable methodology by which the revenue and expense effects related to the inclusion of short term TPUC in rate base could be analyzed and offset, or unless it is demonstrated that there are no revenue or expense effects related to the particular short term construction involved.

Neither the Company nor the Staff has attempted in this case to quantify revenue and expense effects on the test year which might result from inclusion of short term TPUC in rate base. SWB contends that it is unknown whether the quantification of such offsetting effects is possible, and argues that to require same would be to insist upon an unreasonable standard of proof. The Commission does not agree with the Company's position that the possible difficulty involved in making such offsetting quantifications argues in favor of inclusion of short term TPUC in rate base. Rather, inasmuch as the burden of proof in support of increased rates lies with the Company, and since the Commission recognizes a danger that a distorted test year may result from such inclusion without corresponding offsets reflecting increased revenues and cost savings, where applicable, the Commission is of the opinion that short term TPUC should be excluded from rate base unless the party proposing its inclusion can present an acceptable method of quantifying such offsetting effects, or can demonstrate sufficiently that no related offsetting revenue and expense effects are involved. Since no such analysis is presented by the Company in this record, the Commission is of the opinion that short term TPUC should be excluded from SWB's rate base in this case, and the Company's rate base as proposed in this case should be reduced in the amount of $19,436,000.

B. Cash Working Capital

In regard to this issue, SWB has performed a lead/lag study for the purpose of determining the source of the Company's cash working capital requirement during the test year. The Staff reviewed said lead/lag study and proposed an adjustment of an offset to rate base related to interest expense. This Staff adjustment regarding interest expense is the only contested issue in this case in the area of cash working capital, and the value of the issue is $7,452,000 of rate base.

Cash working capital is a rate base item that reflects the Company's need for cash to conduct its day-to-day operations. This cash is investor-supplied capital which the Company must have on hand during the time interval between the incurring of expenses in the provision of service and the reimbursement of those expenditures through the collection of revenues from ratepayers. In recent cases the Commission has accepted the methodology of lead/lag studies, which attempt to quantify the timing differentials in order to arrive at a reasonably precise cash working capital requirement. In this case there is no disagreement between the parties as to the appropriateness of utilizing a lead/lag approach to determine the cash working capital requirement. Rather, the dispute is limited to a question of the proper elements to be included in the lead/lag calculation.

Staff's rationale in including an offset for interest expense in its lead/lag calculation is that the Company collects funds from ratepayers in advance of the date of interest payments, and thus has the free use of those funds during the interim period. Staff characterizes these funds collected in advance of the associated interest payments as being similar to a tax precollection, and argues that such amounts are ratepayer-supplied funds and that the net lag associated therewith should be treated as an offset to the cash working capital requirement.

SWB asserts that accrued interest on debt constitutes investor-supplied funds which should be included in the calculation of rate base through the cash working capital requirement. The Company contends that the Staff has inappropriately mixed elements of two alternative approaches in calculating the cash working capital requirement and that accrued interest on debt should only be considered in the context of a full cost of service approach to a lead/lag study. In such a cost of service lead/lag study the Company contends that the cash flow implications of deferred income taxes, depreciation expense, and net operating income excluding interest would also have to be considered, and that consideration of such items along with accrued interest on debt would substantially increase the Company's cash working capital requirement.

The Commission has previously held that the net expense lag associated with the payment of accrued interest is an appropriate offset to the cash working capital requirement on the basis that such funds are ratepayer-supplied. In so holding, the Commission has pointed out that the obligation to pay interest on debt is known and certain as to the quantity and time of payment, that the amount of funds involved is precollected from ratepayers, and that these ratepayer-provided funds constitute a source of cost-free cash to the Company until such amounts are paid to the bondholders. Re: Kansas City Power & Light Company, ER-81-42 and ER-80-48 (June 1981). No evidence or arguments have been presented which would persuade the Commission to conclude that the funds involved are supplied by investors rather than ratepayers. Therefore, the Commission concludes that Staff's offset to the cash working capital requirement regarding accrued interest is proper.

As to the Company's suggestion that a cost of service lead/lag approach should be utilized if accrued interest on debt is to be considered in the cash working capital calculation, this cost of service approach has been proffered to the Commission on several recent occasions and has been rejected. Re: The Gas Service Company, Case No. GR-81-155 (October 1981); and Re: St. Joseph Light & Power Company, Case No. ER-81-43, et al. (June 1981). The Commission finds no sufficient reason in the record for deviating from its prior determinations that cash working capital should be defined in terms of a utility's day-to-day cash outlays, and that such items as depreciation, deferred taxes and net operating income excluding interest are not properly included in the cash working capital calculation, given that definition.

Based upon these considerations, the Commission concludes that the Staff's adjustment to the cash working capital requirement is appropriate and SWB's rate base in this case should be decreased by the amount of $7,452,000.

C. Summary

Based upon the foregoing adjustments to SWB's proposed rate base, the Commission finds SWB's net original cost rate base for the purposes of this proceeding to be $1,434,741,000.

VI. Fair Value

SWB and the Staff have stipulated as to the amount to be utilized in this proceeding as the fair value of the Company's property. The stipulation and the methodology utilized to reach the fair value figure is contained in the Hearing Memorandum (Exhibit 2). The amount agreed upon between SWB and the Staff is $2,360,000,000. The Commission is of the opinion that the methodology utilized for the calculation and the resulting fair value is reasonable and should be adopted for purposes of this proceeding.

VII. Rate of Return

Evidence was presented in this case by SWB, the Staff, and GSA as to the appropriate capital structure, the Company's cost of common equity, and a resulting rate of return which should be allowed the Company.

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

As expressed in the Hearing Memorandum (Exhibit 2), SWB and the Staff have stipulated to a capital structure and embedded costs of debt and preferred stock for purposes of this case. The capital structure agreed to is based upon double leverage sourcing of SWB's common stock equity utilizing the most current available AT&T (parent only) capital structure. As agreed to between SWB and the Staff, the capital structures and embedded costs of debt and preferred stock of SWB and AT&T (parent only) were updated through the true-up process, such that SWB and the Staff are utilizing AT&T (parent only) capital structure and embedded cost of debt and preferred stock as of August 31, 1981, and SWB capital structure and embedded cost of debt and preferred stock as of September 30, 1981. This double leverage sourcing is based on the premise that SWB's cost of common equity, as a wholly-owned subsidiary, is represented by the parent company's overall cost of capital. The proposed capital structure, as agreed to by SWB and the Staff, and as updated, is as follows:

SWBT Common Equity	Amount (000)	Capitalization Ratio	Cost	Weighted Cost
Common Stock:				
Parent Equity	$ 4,341,371	36.38%		
Parent Preferred	214,677	1.80%	7.67%	.14%
Parent Debt	878,818	7.36%	7.03%	.52%
SWBT Retained Earnings	1,440,054	12.07%		
SWBT Debt	5,059,628	42.39%	9.31%	3.95%

GSA recommends that the Commission use an alternate capital structure for purposes of this case. GSA proposes that the Commission utilize the Bell System consolidated capital structure adjusted to reflect what GSA considers to be a more reasonable equity ratio. GSA's rate of return witness, Mr. Langsam, recommends utilization of the Bell System consolidated capital structure based upon his opinion that it is simple, straightforward, verifiable and introduces no distortions. The Bell System consolidated capital structure presently consists of 51 percent equity. Mr. Langsam considers this equity level to be unreasonably high and is of the opinion that this allegedly high level of equity unduly increases the cost of capital. Based upon this opinion, GSA recommends that the Commission utilize the Bell System consolidated capital structure with a downward adjustment of the equity ratio to the 50 percent level.

Staff witness Shackelford testified that, in his opinion, it is more appropriate to use SWB's capital structure than the AT&T consolidated capital structure. This opinion is based upon the facts that the assets of SWB are supported by its own capital structure, consisting of debt and equity, and that SWB issues its own long term debt while its equity consists of capital contributions made by AT&T and retained earnings. As noted by Mr. Shackelford, the debt of other Bell System operating companies does not support the assets of SWB.

The Commission concludes that the capital structure as proposed by SWB and the Staff is preferable for use in this case. In so holding, the Commission makes no determination as to the reasonableness of the Bell System's consolidated equity ratio. Further, the Commission suggests that the question of the most appropriate debt/equity ratio for the Bell System may be a matter warranting review and analysis by the Staff in future cases.

B. Return on Common Equity

Having determined that the use of SWB's capital structure with double leverage sourcing of the Company's common stock equity is appropriate, a determination is necessary as to the required return on AT&T equity. The required return on AT&T equity is then applied to that portion of SWB's common equity which has been sourced, for purposes of this case, to AT&T parent company equity and to SWB's retained earnings. Evidence was presented as to the required return on AT&T equity by the Company, the Staff and GSA. The recommendations of the parties as to return on AT&T equity are as follows: SWB - 16.8 percent; Staff - 14.7 to 15.5 percent; and GSA - 13.5 to 14.5 percent. SWB and the Staff each presented three witnesses on the return on common equity issue. Each party utilized, to varying degrees, the discounted cash flow (DCF) type of analysis in reaching recommendations as to the appropriate return on common equity. SWB's presentation is based primarily on a DCF analysis and GSA, while utilizing the DCF methodology in its analysis, suggests that certain dangers exist in applying the DCF methodology to AT&T equity in the current market situation. The Staff's case on return on common equity combines use of the DCF methodology and the comparable earnings approach.

The DCF analysis is based upon the premise that current investors value a share of stock by projecting the future flow of dividends and future value of the share of stock, and discount those values to the present time. The DCF attempts to determine the cash flows which an investor can reasonably expect to receive. The DCF formula which embodies this analytical approach is as follows:

$$k = \frac{d}{p} + g$$

In this equation, k represents the investor's required return on common equity; d represents dividends per share; p represents the price of the stock; and g represents an expected growth factor measured in earnings per share or dividends per share. The component of $\frac{d}{p}$ is referred to as the dividend yield component of the DCF equation, while g constitutes the growth component. To account for flotation costs, which are those administrative costs incurred when common stock is issued, the DCF formula is expressed as:

$$k = \frac{d}{p(1-f)} + g$$

The three witnesses appearing on behalf of SWB on this issue, Dr. Linke, Mr. Schelke, and Mr. Geschwind, suggested values to be utilized for both the dividend yield and growth components in the DCF formula. As a result of employing varying assumptions as to a reasonably expected dividend per share over the next 12 months and the use of differing values for the price of AT&T common stock, the three SWB witnesses on this issue have suggested values for the dividend yield component of the DCF formula ranging from 9.8 percent to 10.53 percent. As will be discussed further, infra, the Company's range of values for the dividend yield component are somewhat higher than the range suggested by Staff witness Shackelford. However, The bulk of SWB's evidence on this issue was directed at the question of the appropriate value or range of values to be utilized as the growth component in the DCF equation.

The cornerstone of SWB's recommendation on rate of return on common equity consists of the results of two separate surveys of the institutional investment community conducted by Dr. Linke. The purpose of these surveys was to determine the growth rates which institutional investors expect for AT&T and upon which they base their investment decisions regarding AT&T. Linke's first survey was conducted during

July and August 1980 and his second survey was conducted in April and May 1981. The surveys included all investment firms with discretion over investments in excess of $100 million (13-F companies) and a statistical sample of investment counseling firms (IC firms). The results of the more recent survey indicated growth expectations among institutional investors for AT&T in the range of 6.8 to 7.2 percent for the 13-F companies and 7.1 to 8.9 percent for the IC firms. These growth rates indicated by the more recent survey exceed the 5.5 to 6.5 percent range indicated by the initial survey conducted during the summer of 1980. Utilizing a 10.2 to 10.3 percent dividend yield component in conjunction with the first survey and a 10.5 percent dividend yield component for the second survey, and after making a 50 bases points adjustment relating to flotation and market pressure costs, Dr. Linke's initial survey produced a required return on AT&T equity within a range of 16.2 to 17.3 percent, while the second survey, conducted in the spring of 1981, produced a required return on equity range of 17.8 to 18.3 percent.

Mr. Geschwind's recommendations regarding the growth component of the DCF formula are based upon the growth projections held by various professional analysts at major banks, pension funds and investment houses, with whom Mr. Geschwind maintains contacts in his position as assistant treasurer for SWB. Mr. Geschwind's representations as to the growth projections for AT&T held by these analysts are the result of telephone conversations verified by follow-up correspondence. The projections of approximately 50 professional analysts are involved. According to Mr. Geschwind, the average growth projection for AT&T held by the analysts contacted was 6.1 percent prior to April 1981. The same analysts were contacted again subsequent to April 1981 and the average growth expectation for AT&T held by the analysts was found to have increased to a minimum of 7 percent. SWB attributes the increase in growth expectations for AT&T identified both by Dr. Linke and Mr. Geschwind, in part, to the FCC's authorizing of a 17.4 percent return on equity to AT&T. Geschwind considers a growth rate of 7 percent to be reasonable, if not conservative, in light of the fact that historical trends in the growth of dividends and earnings for AT&T in recent years have exceeded the 7 percent level. Additionally, Geschwind contends that a forward looking implied growth rate methodology would indicate a growth rate as high as 7 to 8 percent as AT&T's achieved return approaches the 15 percent level.

The third Company witness on the rate of return issue was Mr. Schelke, who is a professional telecommunications analyst. Based upon his experience and expertise, Schelke presented his analysis of the growth potential of AT&T. Schelke testified that the factors involved in evaluating the growth potential are the earnings retention ratio, the extent to which common stock is sold above or below book value, and changes in the achieved return on equity. Schelke considers a minimum growth rate for AT&T of at least 7 percent to be reasonable, primarily as a result of the fact that various state regulatory bodies and the FCC have recently authorized equity returns to Bell System companies in the 14 to 15 percent range.

The Staff's recommended range for AT&T return on common equity is based upon the combined results of four separate analyses, two tests using a comparable earnings approach and two tests using a discounted cash flow methodology, including use of both a constant and nonconstant growth DCF model. Mr. Shackelford presented the results of the four tests performed by Staff on this issue, while Mr. Kostbade provided the data supporting the growth value in the Staff's nonconstant DCF formula. Dr. Fish also appeared on behalf of the Staff to present rebuttal testimony regarding Dr. Linke's surveys.

The rationale underlying the comparable earnings approach is generally that a firm's equity investors should be given the opportunity to earn an amount that is commensurate with amounts earned by other firms of similar risk in the capital market. Shackelford performed two comparable earnings tests, one comparing AT&T with a group of non-Bell System telephone companies and a second comparing AT&T to groupings of large industrial firms. In both tests, the factors analyzed were market to book ratios, returns on equity, and equity ratios. Data as to these factors was reviewed for the years 1970 through 1980. In his comparable earnings review of the non-Bell System operating companies Shackelford concentrated his review on the period 1976 through 1980 and found that the companies included in this group had, on average: maintained market to book ratios of 1 or greater; achieved returns on equity averaging in the area of 15 percent; and possessed equity ratios of approximately 35 percent. In comparison, during the period of 1976 to the present, AT&T's market to book ratio was found to have declined from a level greater than 1 to a low point of .73 in 1980, but rebounded to a level of .86 in 1981. During this same period AT&T's achieved return on equity has fluctuated in the range of 10.8 percent to 12.6 percent, while AT&T's equity ratio has been gradually increasing from approximately 47 percent to a level in excess of 51 percent. Shackelford's conclusion is that the data generally indicates the need for a higher AT&T return on equity, especially during periods of poor economic conditions such as those experienced in the last several years. However, Shackelford also points to AT&T's higher equity ratio as evidence of lower financial risk as compared to the non-Bell System telephone companies. Staff's conclusion from this comparable earnings test is that returns on equity for the non-Bell System telephone companies in the range of 15 to 16 percent would provide market to book ratios in excess of 1, and that because of AT&T's higher equity ratio and lower financial risk, a slightly lower range of returns on equity would be appropriate. Staff identifies this range as 14.5 to 15.5 percent.

The second comparable earnings test performed by Staff consisted of the review of average market to book values and returns on equity of firms included in the Standard & Poors 400 and the Compustat Industrial file. The Staff's conclusion based on this review is that, on average, returns on equity in the area of 15 percent will result in favorable investor appraisal in terms of market to book ratios.

As noted previously, Staff has employed both constant and nonconstant DCF models in support of its recommended range of returns on common equity. In its constant growth DCF analysis, a range of dividend yields (prior to adjustment for flotation costs) was developed. Staff chose a range based on the low yield and the average yield experienced during the period 1979 to the present. The resulting range is 9.19 to 9.45 percent. After an adjustment for flotation costs of 3 percent of book value, the Staff's dividend yield component ranges from 9.47 percent to 9.74 percent. In determining values for the growth component in its constant growth DCF model, Shackelford reviewed historic growth of AT&T as measured by growth in dividends per share and earnings per share over the period 1965 to the present. Staff's data includes average percentage increase, average annual compound growth, and trended growth over the period 1970 to the present. Staff's analysis indicates average values in the range of 5.5 to 6 percent, but also demonstrates trended growth in both dividends per share and earnings per share during the year 1980 in excess of 8 percent. Based upon its review of this data, Staff recommends a range of growth rates for its constant growth DCF model ranging from 5.5 to 6 percent. Combined with its range for dividend yield of 9.47 to 9.74 percent, Staff's utilization of the constant growth DCF formula produced a range of returns on common equity of 14.97 to 15.74 percent.

The Staff employed the following values in the calculation of its nonconstant growth DCF formula: a range of $55 to $57 for the price of AT&T common stock; a dividend per share of $5.40; a growth rate for an initial five-year period of 7 percent; and a long term growth rate ranging from 3 to 5 percent. With these values, Staff's nonconstant DCF analysis produced a range of returns on common equity of 14.07 percent to 15.62 percent, with an average of approximately 14.8 percent.

As a final step, Staff combined the results of the two comparable earnings tests, its constant growth DCF test and its nonconstant growth DCF analysis to produce an average range of 14.7 to 15.5 percent for return on AT&T common equity.

GSA's evidence on the issue of an appropriate return on common equity for AT&T was submitted by Mr. Langsam and consisted of a comparable earnings analysis, a market value approach (based on a discounted cash flow analysis) and an analysis of AT&T's growth expectation in the context of current money market conditions. GSA's comparable earnings analysis compares AT&T with large industrial firms and utilities on the basis of various measurements of financial risk. GSA's position is that AT&T's decreasing market values are the result of increasing rates of inflation, increasing long term interest rates, and economic and financial uncertainties affecting the market as a whole, and not as the result of changes in AT&T's business or investment risk. GSA's conclusion is that earnings of 12.5 to 13.5 percent for AT&T are comparable to current earnings of large industrial firms, generally, as a result of AT&T's lower financial risk.

The market value approach is a discounted cash flow type of analysis utilizing dividend yield and growth components. While GSA witness Langsam included a market value analysis in connection with his recommendation as to an appropriate return on AT&T common equity, at the same time Langsam cautioned that this methodology as traditionally applied is unreliable for estimating the Bell System cost of equity capital. According to Langsam, the market value approach assumes that current dividend yield and growth expectations will reflect stable and predictable financial markets and economic conditions. Langsam contends that none of the assumptions associated with the discounted cash flow type of analysis are valid under current economic and financial conditions, and that use of such an approach under such conditions creates the danger that AT&t's cost of equity capital may be overstated. Nevertheless, Langsam specified that AT&T's current dividend yield is in the 10 to 11 percent range, and this fact coupled with an expectation of a small increase in the Bell System's cash dividend indicates to Langsam a near term cost of equity capital ranging from 13 to 15 percent.

GSA's view is that recent and current adverse economic and financial conditions have not adversely affected the Bell System and that, relative to other firms, the Bell System has increased its financial strength. In support of this position, Langsam asserts that Bell System earnings have been more than sufficient to support the acquisition of new debt and common equity capital at reasonable terms and prices. Based on these considerations, GSA recommends that this Commission authorize a return on AT&T common equity of 13.5 to 14.5 percent.

The Staff attacks the evidence supporting SWB's recommendation as to a return on AT&T common equity on various grounds. The primary emphasis of Staff's criticisms relates to the nature of the evidence presented by the Company in support of its growth expectation values for AT&T. The Staff questions whether survey results as to growth expectations are susceptible to proper review for reasonableness by a regulatory body and, further, the Staff argues that survey evidence, as presented by Company witnesses Linke and Geschwind, is inherently tainted by elements of bias and inaccuracy.

The central point of SWB's presentation on AT&T growth expectation is that, through Dr. Linke's surveys, the Company has identified the consensus growth expectation for AT&T. The investors surveyed own 32 percent of the AT&T common stock outstanding and account for 70 percent of the trading activity in said stock. SWB's position is that use of investors' actual growth expectations is essential to proper application of the DCF formula, and that this has been accomplished through the consensus growth identified by Dr. Linke. However, the Commission finds that there are significant problems involved with the general concept of relying primarily upon the growth expectations of actual investors for the determination of an appropriate growth value to be utilized in a discounted cash flow analysis. SWB considers the consensus growth expectation to be embodied in the market price of AT&T stock. Yet, as pointed out by Staff, it is actual investor activity in the market which is the causative factor in the AT&T market price. Therefore, the consensus growth expectation, as identified by SWB through the survey results, is not necessarily identical to the actual growth which will be produced through market activity. SWB's position is that it is the consensus growth rate which is significant and that it is unnecessary to make any judgments as to the reasonableness of individual projections which, in the aggregate, comprise the consensus growth expectation. The Commission cannot agree with this conclusion of the Company. The Commission finds that the growth component of a discounted cash flow analysis should be based upon a level of growth which can reasonably be expected to be sustainable over the long run. In this context, the Commission believes that the determination of an appropriate growth value requires that the Commission be presented with analyses of expected growth which can be reviewed and tested for their reasonableness. The survey results, as submitted by Dr. Linke and, in a less formal manner by Mr. Geschwind, do not allow for review of the reasonableness of the underlying growth projections. Therefore, the Commission does not believe that the growth projections resulting from these surveys are appropriate for utilization in a calculation of a required return on AT&T equity.

SWB criticizes Staff's comparable earnings analyses on the basis that the Staff utilized annual earnings and end-of-period equity in calculating equity returns, and that such a calculation constitutes a mismatching of data with a resulting downward misstatement of equity returns. SWB also attacks the Staff's constant growth DCF model on the grounds that the data utilized by the Staff in making its calculations is based solely on AT&T's historic growth rates for periods extending as far as fifteen years into the past. The Company argues that current economic conditions are vastly different from those experienced ten to fifteen years ago, especially in terms of the inflation rate and interest rates, and that it is unlikely that economic conditions such as those existing as long as fifteen years ago will be experienced in the foreseeable future. Thus, SWB argues that the range of returns on AT&T common equity produced by the Staff's constant growth DCF model is inadequate because of the supporting data utilized.

While the Commission would agree with the Company's assessment that it is unlikely that economic conditions will, in the near future, revert to those existing ten to fifteen years ago, it is a sustainable long term growth level which the Commission deems to be appropriate for use in determining a required rate of return on common equity. As pointed out by GSA in its evidence on this issue, reliance solely upon growth rates experienced during economic conditions such as experienced in the last several years would result an overstated return on common equity when it is long term sustainable growth which is the object of Commission's decision.

The Commission has, for some time, indicated a preference for the DCF methodology as a basis for determining rate of return requirements. This is because it measures current investor expectation for the specific company under scrutiny. In applying the formula, it is important to use data which, as accurately as possible, reflects the actual perceptions of the investor. This is not, however, to denigrate the value of other methodologies in aiding the Commission to reach its decision. In this case we have been presented a wide range of methodologies by the various parties which have been valuable as supportive of the results of the DCF analyses. As can be seen from the foregoing analysis of the evidence before us, substantially all of the tests used by the parties, both DCF and other methodologies, resulted in a range of returns on equity generally between 14 percent and 16 percent, with a preponderance settling near 15 percent. Having considered all of the competent evidence before it, the Commission finds that the appropriate and necessary return on AT&T common equity to be 15.1 percent. Applying this figure to the capital structure noted, supra, results in an overall rate of return of 11.92 percent.

C. Rate of Return Adjustment

The Staff proposes an adjustment through which the overall rate of return level of 11.92 percent authorized herein would not be directly applied to the intrastate rate base for calculation of the revenue requirement. Staff's position is that the overall rate of return permitted by the Commission in this proceeding should be applicable to SWB's total Missouri operations, and that the Commission should establish an intrastate rate of return adjusted downward to reflect the higher 12.75 percent overall rate of return authorized by the FCC in AT&T's most recent interstate rate proceeding.

The adjustment utilizes the existing separations procedures set forth in the NARUC/FCC Separations Manual for the basis of concluding that 71.5 percent of SWB's total Missouri operations are dedicated to intrastate service, with the remaining 28.5 percent of Missouri operations related to SWB's interstate functions. Through this adjustment, Staff would apply the 28.5 percent proportion of interstate operations in Missouri to the 12.75 percent overall rate of return authorized by the FCC, and Staff then determines an intrastate rate of return which, when applied to the 71.5 percent proportion of SWB intrastate operations in Missouri, results in the Commission's overall rate of return level of 11.92 percent. Based on this method, Staff recommends that the Commission authorize in this case an 11.59 percent intrastate rate of return for SWB.

SWB opposes Staff's adjustment and recommends that the overall rate of return determined by the Commission in this case be applied, without adjustment, to the intrastate rate base in the determination of the revenue requirement.

Staff's principal basis for proposing this adjustment is its argument that a higher level of risk is associated with SWB's interstate operations as compared to the risk level associated with the Company's intrastate operations. Since the rate of return allowed should, in some measure, be related to the level of risk associated with a particular endeavor, the Staff argues that the alleged differential in risk requires the establishment of distinct rates of return for the interstate and intrastate portions of SWB's total Missouri operations.

Staff witness Brosch presented testimony in support of the proposed rate of return adjustment. It is Mr. Brosch's opinion that SWB's interstate operations involve a greater degree of risk than its intrastate operations. This conclusion is based upon his evaluation of the extent to which various segments of the Company's operations are subject to competition, or are likely to become subject to competition in the near future. Staff considers the fact that local exchange service is presently a monopoly service, and is likely to remain such for the foreseeable future, as providing a relatively low risk base to SWB's intrastate operations. In this regard, the Staff points out that local exchange service is the source of a substantial portion of the Company's annual revenues. Staff also refers to the interstate toll segment of SWB's operations as an area where the Company is facing increased competition. Mr. Brosch also made an examination of the comparative volatility of interstate and intrastate revenues and found the level of interstate revenues to be significantly more volatile.

SWB makes various arguments in opposition to Staff's proposed rate of return adjustment. The Company contends that acceptance of the Staff's rate of return adjustment would require the Commission to exceed its jurisdiction by making a determination as to the appropriate rate of return for SWB's total (including interstate) return. The Company also argues that the adjustment is impractical because it would place the Commission in a continuously reactive relationship with the FCC in terms of that commission's determinations as to allowed rate of return. Also, the Company suggests that the adoption of a separate and distinct rate of return for Missouri intrastate operations might logically require the Commission also to be in a reactive mode to rate of return determinations made in the various other states in which SWB provides service.

SWB disputes Staff's contention that the Company's interstate operations entail a greater level of risk than that associated with its intrastate operations. In support of its position, the Company emphasizes the fact that it is now subject to competition from unregulated entities in the business and residential terminal equipment markets, which provide a source of revenues on the intrastate level. SWB argues that the Staff has failed to present an evidentiary foundation in support of the alleged risk differential and also contests the validity of Staff's use of the separations factors in making its allocation between interstate and intrastate operations.

The Commission is of the opinion that the evidence presented in this proceeding does not support the type of rate of return adjustment proposed. The Staff has presented no independent analysis of the appropriateness of the FCC's most recent determination by which it authorized a 12.75 percent overall rate of return for AT&T. Additionally, it is not clear that the FCC, in its decision, intended to evaluate only the risks associated with the Bell System's interstate operations in its authorization of the 12.75 percent rate of return. These points are significant since its weighted interstate rate of return is an essential element in producing the Staff's recommended level of return for intrastate operations. The evidence does indicate that certain areas of SWB's operations are subject to various degrees of competitive pressure. However, the evidence presented as to comparative risk levels between interstate and intrastate operations is largely subjective and not quantifiable. Based upon these considerations, Staff's proposed adjustment to the rate of return should be rejected. In so deciding, however, the Commission specifically makes no finding as to whether or not SWB's interstate operations entail a level of risk greater than that of its intrastate operations.

D. Summary

Based upon a finding in this proceeding that AT&T's required return on equity is 15.1 percent, and upon the Commission's rejection of the Staff's rate of return adjustment, SWB is authorized to earn a return of 11.92 percent upon its net original cost rate base.

VIII. Independent Company Settlements

As a matter of stipulation through the Hearing Memorandum (Exhibit 2), and as revised by the calculation contained on page 2 of Exhibit 158, which is the final reconciliation in this case, the parties agree that $6,533,000 should be added to SWB's additional revenue requirement as determined in this case for the purpose of compensating the Company for the increased Independent Company Settlements resulting from the Commission's additional revenue requirement determination. The Commission is of the opinion that this stipulation is reasonable and proper and should be adopted.

IX. Revenue Requirement

Based upon determinations made herein, SWB's total net operating income requirement is $171,021,000. The net operating income available for purposes of this proceeding is $128,263,000, leaving a net operating income deficiency of $42,758,000. After applying a factor for income tax and adding the amount related to Independent Company Settlements, SWB's gross revenue deficiency in this proceeding is found to be $88,286,000.

X. Quality of Service

In addition to SWB, the Staff, Missouri Farm Bureau Federation (Farm Bureau), and the City of Trenton (City) have presented evidence regarding the quality of telecommunications service being provided by the Company in its Missouri service area.

The Company's position is that it is providing high quality telephone service to its Missouri customers and that it is currently meeting all of the Commission's service objectives on a statewide basis. Additionally, the Company feels that its level of service has improved in the past year. The evidence indicates that SWB is currently meeting or exceeding the Commission's quality of service guidelines established in 4 CSR 240-32.080 and that it has made substantial improvements in particular service categories, specifically the clearing of trouble reports within 24 hours and the percentage of customer trouble reports per 100 stations. In support of its position on the quality of service issue, SWB points out that it has opened a complaint bureau with a toll-free telephone number for all Missouri customers and that the Company monitors the quality of service which it is providing through its Telephone Service Attitude Measurement (TELSAM) report, which involves the conducting of a telephone survey of approximately 5,000 Missouri customers per month shortly after these customers have had a business contact with the Company.

Staff's position on the quality of service issue is that SWB is presently providing an acceptable level of service to Missouri customers. This conclusion is based upon the results of investigations performed by two Staff witnesses to review SWB's compliance with the Commission's service objectives set forth in 4 CSR 240-32.080, an analysis of the level of service currently being provided by 24 of the Company's central offices, and an investigation concerning the condition of outside plant facilities in 12 of SWB's Missouri exchanges.

The Farm Bureau's position on this issue is that the level of service to its rural Missouri customers has not improved since 1979. Based upon its evaluation of the level of service being provided by the Company, the Farm Bureau opposes any increase in local exchange rates. The Farm Bureau's opinion regarding the quality of service being provided by SWB is based upon the results of a telephone survey of the Bureau's county offices for the purpose of determining the level of service being provided to Bureau members. The results of the survey express general areas of concern as opposed to specific detailed complaints. The areas of concern identified in the survey are: the length of time required prior to the effecting of repairs to the system, especially for southeastern Missouri customers; the quality of cable in southeastern Missouri; the sufficiency of the number of lines provided by the Company; and the overloading of circuits in Jefferson and Camden Counties. The Farm Bureau also suggests that base rate service areas be broadened in order to permit expanded calling scopes for rural customers into trade centers.

The City of Trenton contends that the quality of service provided by SWB to the City and its citizens is poor and that the rates charged for service are exorbitant. The evidence submitted in support of this position consists of verified statements from 12 residents of the City which generally attest to the experiencing of occasional line interference and problems relating to the placement or receipt of toll calls.

Finally, the position of MoPIRG on the quality of service issue, as indicated by the Hearing Memorandum, is that the Company is providing a level of service in urban areas which is superior to the level reasonably necessary, and that this is a primary cause for the Company's rate requests. However, no evidence was presented at the hearing which would in any way support this proposition.

The record presented leads to the conclusion that the Company is providing an overall acceptable level of service to its Missouri customers and that it is meeting the Commission's quality of service standards. The Commission recognizes the important function to be served by organizations such as the Farm Bureau in monitoring the level of service being provided by SWB to its Missouri customers. However, the Commission is of the opinion that the survey results as presented by the

Farm Bureau are not specific enough in nature such that findings of fact regarding the quality of service provided could be made. In regard to the assertions made by the City of Trenton on the quality of service issue, the Commission takes note of the fact that the City has not availed itself of the opportunity to file a brief in this case even though the quality of service issue was the only issue on which the City presented direct evidence. The record indicates that in regard to several of the service problems alleged by the witnesses appearing on behalf of the City, the problems were either not reported to the Company or were reported and were rectified within a relatively brief period of time. The record also indicates that the Company has upgraded equipment in the Trenton area within the last 18 months and that the level of trouble reports received by the Company from the Trenton area is comparatively low.

While the Commission concludes that SWB is generally providing an acceptable level of service to its Missouri customers, the Staff recommends that the Company be required to submit a schedule for the replacement of all open wire or explain why existing open wire is adequate for the provision of service, and further suggests that SWB update its rural exchange facility maps. The Commission is of the opinion that these recommendations are reasonable and that SWB should comply with these requests within six months of the effective date of this report and order.

XI. Rate Design

A. Company Rate Design Proposal

By its tariff filing of January 9, 1981, which instituted this case, and through testimony submitted in support thereof, SWB alleged an annual revenue deficiency of approximately $129,544,000 and proposed a rate design for recovering said revenue deficiency. SWB's proposal for recovering said revenue deficiency included increases in the following service areas: toll (operator-assisted calls); service connection charges; instrument reprice; local exchange; hotel/motel station charges; and E-911 mileage. The rate design portion of the Hearing Memorandum (Exhibit 3) reflects the Company's rate design proposal utilizing end-of-test-year period (April 1981) quantities, and the use of said quantities results in dollar amounts associated with each service category which differ slightly from those contained in the Company's original tariff filing. Using these end-of-test-year quantities, SWB's proposed rate design package includes the following increases:

Toll		$ 3,413,000
Service Connection Charges		15,306,000
Instrument Reprice		10,453,000
Local Exchange		99,321,000
Hotel/Motel Stations		62,000
E-911 Mileage		70,000
	TOTAL	$128,625,000

On July 31, 1981, the Company filed its amended application in this matter. By said amended application the Company alleged an annual revenue deficiency in this case of approximately $52.6 million in excess of the revenue deficiency specified by the original tariff filing, resulting in a total annual revenue deficiency of approximately $182.1 million. In conjunction with the amended application, SWB submitted supplemental testimony in support of the additional revenue deficiency, and tariff sheets (without requested effective dates) as an exhibit for the purpose of suggesting a proposed rate design for the recovery of any revenue deficiency as determined by the Commission in excess of approximately $129 million. The rate design suggested by the Company for the purpose of recovering any such "excess" revenue deficiency is as hereinafter set forth:

Toll (directly-dialed long distance) and WATS	$16,972,000
Instrument Reprice (in addition to amount contained in original filing)	3,026,000
Local Exchange (in addition to amount contained in original filing)	19,011,000
Hotel/Motel Stations (in addition to amount contained in original filing)	16,000
E-911 Mileage (in addition to amount contained in original filing)	16,000
Private Line	2,058,000
General Exchange and Mobile	12,378,000
TOTAL	$53,477,000

The dollar amounts reflected in the amended application reflect end-of-test-year quantities. When combined with the rate design package included in the original tariff filing, the total alleged annual revenue deficiency of $182.1 million is covered. During the true-up hearing held in this case, SWB presented updated dollar amounts associated with the primary (revenue deficiency up to $129.544 million) and "excess" (revenue deficiency in excess of $129.544 million) rate design packages. These updated dollar amounts are based on September 30, 1981, quantities, and inasmuch as these quantities represent the most current data and are not disputed by other parties, the Commission's determinations regarding rate design will be based on these September 30, 1981, quantities. SWB's resulting primary and excess rate design packages are as follows:

SWB Primary Rate Design Package

Toll (operator-handled calls)	$ 3,576,000
Service Connection Charges:	
Multi-element	14,361,000
Dual element	11,393,000
Instrument Reprice	10,518,000
Local Exchange	99,831,000
Hotel/Motel Stations	62,000
E-911 Mileage	69,000

SWB Excess Rate Design Package

Toll (directly-dialed long distance) and WATS	$17,933,000
Instrument Reprice (in addition to amount contained in primary rate design package)	3,030,000
Local Exchange (in addition to amount contained in primary rate design package)	19,147,000
Hotel/Motel Stations (in addition to amount contained in primary rate design package)	15,000
E-911 Mileage (in addition to amount contained in primary rate design package)	16,000
Private Line	2,437,000
General Exchange and Mobile	12,443,000

The specification of amounts for service connection charges in SWB's primary rate design package reflects the fact that while the Company proposed, in its original application, an increase in rates in the existing multi-element service connection rate design, SWB has requested that the Commission also review an alternative dual element service connection rate design which entails a different revenue effect. The dual element proposal was the subject of a hearing in Case No. TR-82-14 and the Commission considers it appropriate to review both proposals simultaneously. Therefore, Case No. TR-82-14 is hereby consolidated for decision with Case Nos. TR-81-208 and TO-78-46. Thus, the dollar amounts identified above in the Company's primary rate design package for multi-element and dual element service connection charges are alternative rather than additive amounts. Depending on the choice between dual element or multi-element service connection charges, SWB's primary rate design package using September 30, 1981, quantities provides for the recovery of either $125,499,000 (dual element) or $128,417,000 (multi-element). Using September 30, 1981, quantities, SWB's excess rate design package would recover revenues of $55,021,000.

B. Stipulated Revenue Allocation

All parties to the proceeding have stipulated, through the Hearing Memorandum (Exhibit 3), that certain rate changes contained in SWB's rate design proposal should be implemented regardless of the revenue requirements authorized by the Commission. The rate changes agreed to by the parties are: Company's proposed increase in operator-handled toll calls ($3,576,000); Company's proposed increase in E-911 mileage rates ($69,000); Company's proposed elimination of certain EAS additives ($216,000 decrease in revenues); and Company's proposed rearrangement of certain central exchange boundary lines ($400,000 decrease in revenues).

C. SWB's Priorities For Rate Design Implementation

SWB's evidence includes a recommendation as to priorities regarding the order of implementation of elements of its rate design package in the context of the ultimate revenue deficiency which the Commission finds to exist in this case. SWB suggests that for any revenue deficiency up to approximately $129 million, that the Commission first authorize the elements of the Company's primary rate design package other than the increase in local exchange rates. Any revenue deficiency in excess of the amounts recovered by the increases in said elements and up to a total of approximately $129 million would then be recovered by increases in local exchange rates. The priority items which the Company suggests should bear the first portion of any revenue deficiency include service connection charges (either $11.393 million or $14.361 million, depending on whether the dual element or multi-element Company proposal would be adopted); instrument reprice of $10.518 million; hotel/motel guest station rates of $62,000; elimination of certain EAS additives and revision of certain exchange boundary lines, decreasing revenues by $216,000 and $400,000, respectively. Thus, using September 30, 1981, quantities, and assuming approval of either the Company's dual element or multi-element service connection charge plan, SWB's priority rate design items would cover either $25,002,000 (dual element) or $27,970,000 (multi-element). Under the Company's proposal any revenue deficiency in excess of these amounts and up to approximately $129 million should be recovered by increases in local exchange rates.

SWB's position is that its priorities for the recovery of any revenue deficiency in this case are consistent with the concept of residual pricing of basic service as mandated by the Commission's order in Re: Cost of Service Study of Southwestern Bell Telephone Company, Case No. 18,309 (May 1977). SWB contends that the Commission should authorize significant increases in local exchange rates prior to initiating increases in rates for other Company services, such as general exchange, private line, toll (direct-dialed long distance), WATS, and mobile telephone. SWB argues that these latter named services have absorbed significant rate increases as the result of the Company's two most recent Missouri rate cases. In the Company's opinion, in addition to the priority elements of the Company's primary rate design package specified above, only the local exchange category provides, at this time, a reasonable source for the generation of significant additional revenues. SWB also points out that local exchange rates, as a category, have not been increased since 1976.

Based upon the foregoing line of analysis, SWB states that its rate design proposal in this case is consistent with the concept of residual pricing and the Commission's holding in Case No. 18,309. However, SWB suggests that the Commission should narrow the definition of what should constitute a benefited service to include only access to the local network. SWB's rationale in support of this suggestion is that various regulatory and judicial decisions are creating increased competition for the Bell System in the provision of various telecommunications services and that the movement toward deregulation on the federal level will eventually result in the detariffing of certain services which presently provide contribution to the local exchange category. The Company's argument implies that significant increases in local exchange rates should be approved currently in order to avoid the dramatic impact on local exchange rates which would result from holding said rates at a relatively low level presently with the prospect of various revenue-producing services being detariffed in the near future.

D. Rate Design Proposals Submitted by Other Parties

1. Staff Rate Design Proposal

As indicated in the Hearing Memorandum (Exhibit 3) Staff, in this case, has proposed a rate design package which is essentially the same as that offered by SWB. The only difference between the rate design packages of the Company and the Staff, as specified in the Hearing Memorandum, relates to service connection charges. Inasmuch as the Company and the Staff have jointly proposed a modified dual element plan for service connection charges in Case No. TR-82-14, the Staff's rate design proposal, using September 30, 1981, quantities, would result in coverage of $25,002,000 of any revenue deficiency. Staff is in agreement with Company as to the recommendation that any revenue deficiency in excess of the amount covered by priority items should be recovered through increases in local exchange rates. Staff's rationale in support of this position is basically the same as that submitted by the Company.

2. Public Counsel Rate Design Proposals

In support of its alternative rate design proposals, Public Counsel takes issue with two of the general concepts underlying SWB's suggested rate design in this case. First, Public Counsel disputes the validity of the Company's embedded direct analysis (EDA) as a basis for determining the contribution levels associated with the various categories of the Company's services. Secondly, Public Counsel alleges that the rate design proposal offered by SWB is directly contrary to the concept of residual pricing for basic telephone service.

Public Counsel's argument regarding the validity of SWB's EDA revolves around the issue of the appropriate allocation of access line costs, which include the drop, cable pair to the central office, the central office equipment dedicated to the line, and station connection investment and billing costs. The EDA compares revenues and direct costs (those costs directly attributable to the service in question) for various broad categories of services provided by the Company. Any excess of revenues over direct costs provides a contribution to the joint and common costs of the Company. Under SWB's current EDA methodology, access line costs are treated as direct costs of providing local exchange service. The central point of Public Counsel's argument regarding the allocation of access line costs is that these costs include the costs of facilities which are used jointly for local exchange, intrastate toll, interstate toll, international toll and other services. Based upon this reasoning, Public Counsel contends that the allocation of all access line costs to local exchange service creates an "illusion" that local exchange service is being "subsidized" by various other categories of the Company's services. SWB's 1980 EDA indicates that local exchange service is providing revenues in excess of direct costs (excluding access line costs) in the amount of $119 million. Allocation of all access line costs of $299.1 million to the local exchange category produces the result that local exchange service makes a negative contribution of approximately $180 million. It is Public Counsel's position that if access line costs were allocated in a proper manner between the local exchange, intrastate toll and interstate toll categories, local exchange service would be found to be making a positive contribution to the Company's joint and common costs.

Public Counsel also disagrees with SWB's contention that the Company's proposed rate design package is consistent with the concept of residual pricing as established by the Commission in Case No. 18,309. In support of this argument, Public Counsel points to the fact that SWB, in its most recent previous Missouri rate case, Case No. TR-80-256, proposed increases in various services such as toll, WATS, vertical business and residence, private line and mobile services, of amounts significantly greater than the rate increases ultimately resulting from the settlement of that case. Public Counsel argues that this constitutes an acknowledgement that various nonbasic services are appropriate candidates for rate increases in the instant proceeding, even though SWB has not sought such increases through its suggested rate design. Public Counsel also points to the "excess" rate design package suggested by SWB for application to any revenue deficiency in excess of approximately $129 million, with the implication that the appropriateness of the rate increases recommended by the Company in its "excess" rate design package should not be dependent upon the amount of the Company's revenue deficiency in this case.

Relying to a large extent upon the arguments recited above, Public Counsel makes various recommendations in support of a rate design alternative to that proposed by the Company. It is Public Counsel's position that present rates for many of SWB's competitive services, including vertical and private line services, remain at inadequate levels and result in inadequate contributions to the Company's joint and common costs. Public Counsel suggests that the Commission substitute a rate design in which a larger portion of the overall revenue requirement is placed on competitive, vertical, and private line services, with a lesser portion of the overall burden placed upon basic services. Specifically, Public Counsel suggests: intrastate long distance rates be increased by a minimum of approximately 16 percent; intrastate private line rates be increased by an average of approximately 20 to 25 percent; vertical services supported by incremental unit cost studies be priced to produce a minimum contribution level of at least 75 percent, with the possibility of a transitional increase to the 50 percent level; and that any increase in service connection charges be limited to the overall percentage increase in revenues granted in this case. Public Counsel also recommends that the Commission reject the Company's proposal to implement local measured service (LMS) on a permanent basis, and requests that the Commission initiate a separate proceeding to investigate the implications of the FCC's Second Computer Inquiry decision (docket no. 20828).

3. State of Missouri's Position on Rate Design Issues

The State of Missouri has submitted testimony and arguments regarding its opinion as to an appropriate rate design to be established in this case. In general, the State is in agreement with SWB and the Staff as to those parties' suggestions for spreading any revenue deficiency found to be existing. Specifically, the State opposes certain recommendations of the Public Counsel regarding proposed increases in intrastate private line and WATS rates in this proceeding.

The State's opposition to any increase in private line or WATS rates relies basically on three points of argument. First, the State references the amount of increases in rates for these offerings which have occurred as a result of SWB's two most recent Missouri rate cases, Case No. TR-79-213 and Case No. TR-80-256. SWB's annual revenues from private line services have increased by $16.4 million as a result of these two most recent rate cases. This represents a 180 percent increase in private line rates. Secondly, the State argues that the Public Counsel has not submitted adequate evidence in support of its recommended increase in private line rates to establish that such increases would not actually produce a reduction in customer usage and, thus, fail to generate the total additional revenues predicted. Public Counsel's proposal is to increase private line rates by approximately $9.3 million. The State has reduced its usage of SWB's private line services at least partially in response to the rate increases which have occurred within the past two years. Since the State of Missouri is a substantial user of these services, it is the State's contention that its reaction to these recent increases in private line rates is probative as to the likely future reaction of both the State and other private line customers. Finally, the State disputes the validity of Public Counsel's use of data in arriving at its conclusion that private line and WATS rates should be increased. The State's contention is that Public Counsel's use of SWB's 1979 and 1980 embedded direct analyses (EDAs) in support of the suggested increases is improper since the EDA reflects historic or embedded costs. The State's position is that private line and WATS services are subject to a degree of competitive pressures and that the setting of rates for these services should be dependent upon market analysis such as is provided through a LRIA. The State also points to the fact that the Commission has recognized that revenues from private line services have not been recovering the associated direct costs of providing the services, and that the Commission, in Case No. TR-78-235 (report and order issued October 1979) has embarked upon a course of gradually increasing private line rates over a reasonable period of time. The schedule established in said case calls for the submission of the results of a Company-performed LRIA study in February 1982. The State suggests that it would be inappropriate to authorize any increase in private line rates outside of the schedule established in Case No. TR-78-235.

4. Armco's Position on Rate design

Armco, Inc. (Armco) is basically in agreement with the position taken by Staff regarding the proper allocation of any additional revenue requirement determined in this case. Armco specifically opposes Public Counsel's recommendation that rates for business vertical services be increased. The basis for Armco's opposition to any such increase is that annual revenues produced by such services have grown by nearly $80 million as the result of increased rates established in SWB's two most recent Missouri rate cases, while rates for basic services have either remained stable or, in some instances, have been reduced below 1975 levels. Armco suggests that no significant increases in the level of contribution to joint and common costs can be derived from further increasing rates for business vertical services and, therefore, argues that the Commission should not authorize any increase in such rates in this proceeding.

5. MoPIRG Position on Rate Design

MoPIRG generally contends that by its rate design proposal in this case SWB is improperly attempting to place the burden of any rate increase primarily upon residential customers, and that prior to the authorization of any increase in rates for basic service, the Commission should require that rates for all Category One and

Category Three services (as defined in Commission Case No. 18,309) be increased so as to produce contribution levels of 100 percent and 75 percent, respectively.

6. Missouri Hotel and Motel Association Position on Rate Design

Missouri Hotel and Motel Association (MHMA) is in agreement with the position of the Staff regarding an appropriate rate design package, with the exception of two specific issues. MHMA opposes the Company's proposal to increase the rate for hotel and motel guest station lines from 30 cents to 50 cents, and also opposes the Company's request regarding the repricing of telephone instruments, which would include those instruments installed in hotel and motel guest rooms, from $1.15 to $1.50 for rotary telephone instruments and from $1.85 to $2.50 for touch-tone telephone instruments. MHMA's position is that the Company has historically maintained a differential by which rates for hotel and motel guest station lines and for instruments connected thereto have been lower than line and instrument charges for telephones connected to general business PBXs. MHMA contends that the Company has presented no study which would justify the elimination of this differential and, also, affirmatively argues that average occupancy rates well below 100 percent result in reduced accessing costs and variable maintenance costs to the Company, and that use of hotel and motel guest room phones generally occurs during offpeak hours, resulting in reduced cost of network accessing. For these reasons, MHMA requests that the Commission reject SWB's rate increase proposals regarding hotel and motel guest station lines and instrument reprice as affecting instruments installed in hotel and motel guest rooms.

E. Commission Conclusions as to Appropriate Rate Design

1. Residual Pricing of Basic Service

The concept of residual pricing of basic service was established by the Commission as a fundamental principle of pricing for SWB's various categories of service in Re: Cost of Service Study of Southwestern Bell Telephone Company, Case

No. 18,309 (May 1977). The decision in said case stands as a framework for future cost and rate determinations for SWB in Missouri. By said decision the Commission recognized three general categories of service provided by the Company. Category One was defined to include all those services subject to substantial competitive pressure; Category Two was defined as including all those services considered to compose "basic telephone service"; and Category Three was defined to include the balance of all other services not included in either Category One or Category Two. Having defined these categories of services, the Commission then established pricing policies for each of the categories. The Commission held that Category One services (those subject to substantial competitive pressure) would be priced so as to generate the largest practical level of contribution from those services to joint and common costs and to basic service based upon long run incremental analysis (LRIA). The Commission further held that Category Three services (nonbasic services not subject to substantial competitive pressure) are to be priced using long run incremental analysis as a foundation, while adjusting for social or economic factors related to the provision or receipt of those services. Basic service (Category Two) is then to be priced <u>residually</u> after taking into consideration any contribution to joint and common costs made by Category One and Category Three services. The residual pricing concept is founded upon the regulatory goal of the promotion of universal telephone service.

SWB states that it continues to adhere to the concept of residual pricing of basic service but argues that the exigencies of the current and likely future telecommunications environment require that basic service begin to bear a substantial portion of the burden of the Company's revenue requirements. The basis for this position is the Company's contention that the introduction of competition into various segments of the Company's telecommunications services will result in the elimination of traditional sources of contribution to joint and common costs and will ultimately require substantial increases in rates for basic service. In this context, SWB apparently used its proposed rate design package as an initial step in increasing the share of the revenue requirement burden borne by rates for basic service.

It is undeniable that SWB is currently facing competition with respect to various areas of its operations from unregulated firms where once the Company held monopoly positions. However, there appears to be great uncertainty surrounding the question as to how rapidly various aspects of the Company's services will be transferred from a regulated to a detariffed and fully competitive environment. In this regard the Commission takes administrative notice of the fact that the FCC has delayed the initial phase of its deregulation of Customer Premises Equipment (vertical services) in docket no. 20828 from March 1, 1982, until January 1, 1983. Additionally, the first phase of said deregulation involves only newly installed Customer Premises Equipment. It is uncertain as to the period of time which will be involved in the detariffing of the embedded investment in Customer Premises Equipment. Thus, while SWB may be subject to a level of competitive pressure not previously experienced, the Commission concludes that the circumstances do not warrant the abandonment of the residual pricing concept for basic service, and the Commission herein reaffirms its adherence to the residual pricing concept.

2. <u>Allocation of Access Line Costs</u>

As noted previously, Public Counsel contends that the present allocation of costs contained in SWB's embedded direct analysis (EDA) improperly assigns all access line costs to be borne by local service revenues in the determination of contribution levels. The Commission believes that the arguments set forth in support of that position raise a significant question as to the present methodology embodied in the Company's EDA for the identification of contribution levels by the various categories of services. Since the specification of contribution levels is an essential prerequisite to determinations utilizing a residual pricing concept, the issue of the proper allocation of costs in measuring such levels is a matter of great importance in establishing an appropriate rate design for SWB. The Commission is of the opinion that, because of the importance of this issue and the substantial effect on rate design considerations which are inherent in a determination thereof, the matter of the appropriate allocation of access line costs for the purpose of identifying contribution levels should be treated as the subject of a separate Commission docket. Such treatment will allow for full and separate consideration of this issue outside of the statutory time constraints associated with the Company's tariff filings.

3. Approved Rate Design Package

As indicated by the discussion above, the concept of residual pricing of basic service is utilized herein for the establishment of an appropriate rate design. The residual pricing concept requires that the Commission investigate the possibility of increasing rates for the Company's nonbasic services before turning to basic service. Based upon all of the relevant evidence and arguments submitted, the Commission deems a rate design which will recover the following specified portions of SWB's revenue deficiency is appropriate for implementation in this case.

Toll (operator-handled)	$ 3,576,000
Toll (directly-dialed long distance) and WATS	17,933,000
Service Connection Charges	11,393,000
Instrument Reprice	13,548,000
Hotel/Motel Guest Station Rates	62,000
E-911 Mileage	85,000
Private Line	2,437,000
General Exchange and Mobile	12,443,000
Elimination of EAS Additives	(216,000)
Exchange Boundary Rearrangements	(400,000)
Local Exchange	27,425,000

The above-described rate design, which shall be implemented in this case, consists of the following basic elements: (a) the priority items contained in SWB's primary rate design package; (b) the items contained in SWB's excess rate design package, with the exception of the related increase in local exchange rates and hotel and motel guest station line rates; and (c) the residual amount of the revenue deficiency not covered by those increases contained in (a) and (b), to be recovered through increases in local exchange rates.

The excess rate design package proposed by SWB consists of a 16 percent increase in directly-dialed long distance rates and rates for WATS service, coupled with a 6.5 percent increase in recurring rates throughout all of the Company's categories of service. As noted previously, SWB proposed implementation of the excess rate design package only under the circumstances of a finding by the Commission of a revenue deficiency in excess of approximately $129 million. Apparently, the Company's rationale in support of this position is that local exchange rates required an increase resulting in approximately $100 million in increased annual revenues prior to making it appropriate to implement the excess portion of the rate design package. However, the Commission considers the fact that SWB has suggested that the items contained in the excess rate design package may be appropriate for various amounts of rate increases makes less persuasive the Company's argument that it has, in its primary rate design package, exhausted the possibilities of increasing rates for nonbasic services prior to turning to local exchange service. The Commission believes that, in the context of the size of the revenue deficiency found to be existing in this case and the portion of the revenue deficiency which will be borne by local exchange service, the utilization of the items contained in SWB's excess rate design package is reasonable and consistent with the concept of residual pricing for basic service, even though the Company's revenue deficiency has been found to be substantially less than $129 million.

Certain further explanation of the rate design to be implemented in this case is appropriate at this point. The rate changes reflected for operator-handled toll, E-911 mileage and the elimination of certain EAS additives and the revision of certain exchange boundary lines were matters of a stipulated revenue allocation among the parties, except that the amount indicated for E-911 mileage also includes the 6.5 percent increase from application of the Company's excess rate design package. The Commission finds this stipulated revenue allocation to be reasonable and proper. The amount contained in the approved rate design for directly-dialed long distance and WATS service reflects a 16 percent increase in those rates. Such an increase will restore parity between intrastate and interstate toll. The Commission considers it appropriate, at this time, to maintain this parity relationship without prejudice to any future consideration of this issue in the existing Intrastate Toll docket, Case No. TO-81-292. Additionally, the Commission has normally maintained a tie between increases in rates for intrastate toll and WATS service. The rate increase contained in the approved rate design will continue this relationship. The amount of increase contained in the approved rate design for service connection charges reflects the adoption of the modified dual element plan agreed to between SWB and Staff in Case No. TR-82-14. Further discussion of that issue can be found, infra. The amount of increase included in the approved rate design for instrument reprice combines the increase sought by SWB through its primary rate design package with the effect of the 6.5 percent recurring rate increase from the excess rate design package. Public Counsel has argued that the proposed rate increase relating to Rotary 500 instruments should be denied on the basis that said instrument constitutes a part of basic service. However, the evidence indicates that SWB is now subject to competition in the provision of telephone instruments, both for residential and business customers, and, in this context, the Commission concludes that it would be inappropriate to shield the Rotary 500 instrument from the effect of otherwise appropriate rate increases. The amount of increase for hotel and motel guest station lines included in the approved rate design gives effect to the rate increase proposed by the Company in its primary rate design package, but does not include application of the 6.5 percent recurring rate increase which is a part of the excess rate design package. The Commission considers this approach to be reasonable in that it provides for an increase in these rates but allows the continuation of a differential between hotel and motel guest station line rates and rates for lines connected with general business PBXs. The rate increases included in the approved rate design for private line services and general exchange and mobile services are produced solely by the application of the 6.5 percent recurring rate increase contained in the Company's excess rate design package. SWB did not propose increases in rates for these services through its initial filing in this case. While the Commission is cognizant of the fact that rates for these services have been subject to significant increases in recent years, the amounts of increases included in the rate design approved in this case are not unreasonable considering the extent of SWB's revenue deficiency. Specifically in regard to private line rates, SWB is scheduled to present the results of a private line LRIA study in February 1982 in Case No. TR-78-235. The Commission recognizes that the level of private line rates established as a result of this case may require adjustment depending upon the results of the Company's study. However, this fact should not foreclose the option of increasing private line rates in this proceeding. SWB proposes that any increase in local exchange rates be structured utilizing the relationships approved by the Commission in Case No. TR-79-213, except that the Company recommends that relatively minor revisions be made in the rate relationships of flat rate trunk, information terminals and multiline service as compared to the 1FB rate. These suggested revisions of rate relationships within local exchange service are consistent with the results of SWB's Exchange Class of Service study. The Commission is of the opinion that the internal rate structure for local exchange service as proposed by SWB in this case is reasonable and should be authorized.

4. Service Connection Charges

As noted previously in this report and order, the original tariff filing by SWB in this case included a proposed repricing of service connection charges under the Company's current multi-element service connection rate design. The annual revenue effect associated with said multi-element reprice proposal (utilizing September 30, 1981, quantities) is $14,361,000. Subsequent to its initial filing in this case, SWB submitted to the Commission the results of a dual element cost study and a dual element service connection rate design proposal based upon said study. Again, utilizing September 30, 1981, quantities, the annual revenue effect of the dual element service connection charge proposal is $11,393,000. The dual element tariffs were suspended under docket no. TR-82-14 and SWB's request to consolidate consideration of the dual element proposal with the instant rate proceeding was denied by the Commission. However, a timely hearing was held in Case No. TR-82-14 in order to allow the Commission the opportunity to consider simultaneously the Company's multi-element and dual element rate design proposals. As also previously indicated in this report and order, the Commission considers it appropriate to consider both of said service connection charge proposals simultaneously and Case No. TR-82-14 has been consolidated with Case Nos. TR-81-208 and TO-78-46 for the purpose of permitting such simultaneous consideration.

While the Company considers the dual element cost study and the resulting service connection rate design to constitute an improvement in methodology over the existing multi-element rate structure, prior to the hearing in Case No TR-82-14 SWB's position was that service connection charges needed to be increased and that the Commission should approve either the repricing of the Company's multi-element rate design or the newly-submitted dual element proposal. The main argument advanced by SWB for the increasing of service connection charges rests on the fact that said charges have not been increased since 1976 in Commission Case Nos. 18,660 and 18,661 (December 1976), and that the resulting rates from said case were based upon a 1975 cost study and were specifically set below relevant costs as then defined. At the hearing in Case No. TR-82-14, SWB and the Staff entered into a Stipulation and Agreement by which said parties recommend that the Commission approve a modified version of the Company's dual element service connection charge proposal (hereinafter referred to as "modified dual element plan").

The dual element cost study methodology and the resulting dual element service connection charge proposal originally filed in Case No. TR-82-14 utilized two general categories for the analysis of costs related to the Company's service connection activity. These two general categories include a service and equipment (S&E) cost element and a time-sensitive premises work charge by which the costs related to the actual work performed in making the service connection would be measured in 15-minute increments. This dual element cost study methodology would allocate the service and equipment cost element and the premises work element to three separate categories of customers: standard residence, standard business and complex customers. The complex customer classification refers to those customers who subscribe to key telephone service or PBX/Centrex service, while standard residence and business customers are those customers subscribing to single-line service. The S&E cost element identifies and distinguishes between applicable service and equipment costs for the provision of the access line, and for various groups of products considered to be similar in nature, designated as major product types, which results in the separate identification of service and equipment costs for various forms of residential and business service. The Company's dual element cost methodology developed a time-sensitive premises work charge for standard residence and standard business customers, but the Company has, at this time, been unable to develop what it considers to be an adequate method for developing a time-sensitive premises work charge for complex customers. SWB's current multi-element service connection rate design includes two service ordering charges (one each for residence and business customers) and two central office access charges (again, one each for residence and business), while the dual element proposal is more specific in that it includes S&E rates for various major product types and services and replaces the two existing central office access charges with six individual S&E charges. Additionally, under the existing multi-element rate design, a customer pays the same charge to connect telephone service, to have his telephone number changed, or to change from two-party to one-party service, whereas under the dual element rate design methodology there is a separate and distinct charge for each of these functions to reflect the varying degrees of work involved in each.

The modified dual element plan which is now jointly recommended by SWB and the Staff contains various revisions to the Company's initial dual element proposal. These revisions were made in response to criticisms voiced by the Staff in its prefiled testimony in Case No. TR-82-14. Most of the Staff's criticism was directed toward the accuracy of the identification of costs for particular items under the installation charges. Staff was also opposed to the fact that SWB's initial dual element proposal would have instituted time-sensitive premises work charges for standard residence and standard business customers, but not for complex customers. Staff's position on this point was that the implementation of time-sensitive premises work charges should be accomplished for all customers simultaneously. As the result of the criticisms made by Staff on this point, SWB agreed to withdraw its time-sensitive premises work charges until such time as it is able to include complex customers in such a cost element. In the meantime, all customers' premises work charges under the modified dual element plan would continue to be "flat rate" in nature and would be separated into the following elements: trip, station handling, premises wiring, and jack. However, the new S&E rates which are part of the

Company's dual element proposal would replace the service order and central office access charges which currently exist under the multi-element service connection rate design. Although the Staff is still not satisfied with the totality of SWB's dual element cost methodology, it is Staff's position that, with the revisions agreed to by SWB, the modified dual element plan constitutes an improvement over the current multi-element rate design, and on this basis the Staff recommends adoption of the modified dual element proposal. Staff's willingness to recommend adoption of the modified dual element plan is based, in part, on the Staff's evaluation that said modified plan will still result in recovery of considerably less than 100 percent of the relevant costs through the service connection charge. The basis for this evaluation is the Staff's contention that disconnection costs should be treated as an element of service connection costs.

The following tables illustrate differences in rates between the existing multi-element and the proposed modified dual element service connection plans. The reference to "Full Participation" for residence customers reflects the charge which a residential customer will incur if full participation at a Phone Center Store is involved. Full Phone Center Store participation requires that the customers pick up telephone sets from the Phone Center Store and install the instruments themselves.

Residence - Full Participation (One Basic Set)

Rate Elements	Present Rates	Dual Element - Stipulated Rates
Service Ordering Charge	$ 9.00	---
Central Office Access Charge	10.00	---
Service and Equipment Charge:	---	---
-Access Line	---	$21.90
-Telephone Set	---	3.75
Total	$19.00	$25.65

Residence - No Participation (One Basic Set)

Rate Elements	Present Rates	Dual Element - Stipulated Rates
Service Ordering Charge	$ 9.00	---
Trip Charge	7.00	$ 9.25
Central Office Access Charge	10.00	---
Station Handling Charge	3.00	4.75
Premises Wiring Charge	4.80	10.75
Jack Charge	6.20	6.20
Service and Equipment Charge:	---	---
-Access Line	---	21.90
-Telephone Set	---	3.75
Total	$40.00	$56.00

Standard Business - No Participation (One Basic Set)

Rate Elements	Present Rates	Dual Element - Stipulated Rates
Service Ordering Charge	$18.00	---
Trip Charge	10.00	$11.75
Central Office Access Charge	17.00	---
Station Handling Charge	6.00	6.25
Premises Wiring Charge	12.80	15.25
Jack Charge	6.20	6.20
Service and Equipment Charge:	---	---
-Access Line	---	26.90
-Telephone Set	---	3.75
Total	$70.00	$70.10

Complex Business - No Participation

Rate Elements	Present Rates	Dual Element - Stipulated Rates
Service Ordering Charge	$18.00	---
Trip Charge	10.00	$27.00
Central Office Access Charge	17.00	---
Station Handling Charge	6.00	6.25
Premises Wiring Charge	15.00	16.00
Jack Charge	6.20	6.20
Service and Equipment Charge:	---	---
-Access Line	---	26.90
-Telephone Set	---	3.75
Total	$72.20	$86.10

Public Counsel and MoPIRG are opposed to the modified dual element plan jointly advocated by SWB and the Staff. The general basis for Public Counsel's opposition is its contention that the cost methodology underlying the Company's initial dual element proposal and the modified dual element plan is contrary to standards previously indicated by the Commission to be necessary for an adequate service connection cost study. MoPIRG argues that the existing service connection charges are fully compensatory and that there is an overriding social necessity for noncompensatory installation charges. Additionally, MoPIRG contends that disconnection costs should not be included in service connection rates.

The Commission, in Re: Southwestern Bell Telephone Company, Case No. TR-78-242 (November 1979), outlined certain standards then considered to be necessary for an appropriate service connection cost study. Therein, the Commission stated that a proper service connection cost study should:

> Exclude costs associated with vertical services to enable the Commission to determine the service connection move and change costs associated with basic service;
>
> Clearly state the range of cost variations within the large rate classifications to enable the Commission to determine whether the classifications are appropriate for ratemaking purposes;
>
> Exclude the capitalized costs, the interstate portion of costs and disconnection costs associated with service connection, move and change activities; and
>
> Base the study upon marginal costs rather than average total costs.

Public Counsel's opposition to the modified dual element plan results primarily from the facts that the dual element cost study as performed by SWB makes no attempt to allocate the total costs identified between those costs which should be considered for intrastate ratemaking purposes and those which should be allocated to the interstate jurisdiction, and, also, on the basis that the modified dual element plan includes a small portion of disconnect costs in its calculation. While Public Counsel implies that failure of the Company to exclude interstate costs from the dual element cost study may result in a double recovery by SWB of its service connection costs, there is no basis in the record for this proposition inasmuch as there is no evidence to indicate that the FCC authorizes an interstate service connection rate. Rather, the concern expressed by Public Counsel regarding the failure to exclude interstate costs goes more to the question of whether the costs upon which service connection charges are based by this Commission may be overstated and, thus, possibly result in uncontemplated subsidization of other Company services by the service connection charge. Public Counsel's argument in favor of the exclusion of interstate costs from a service connection cost study is based on the concept that the service connection makes possible the use of local exchange, intrastate and interstate toll facilities, and that it is therefore reasonable that the costs associated with service connections be allocated between intrastate and interstate jurisdictions. Public Counsel's suggestion for the method of allocating between intrastate and interstate service connection costs is to utilize the Subscriber Plant Factor (SPF), which is a factor utilized in the separations process. The separations process involves an arbitrary, politically agreed upon allocation of various broad categories of costs to the interstate jurisdiction for the purpose of determining an allocation to individual states of interstate toll revenues. While the evidence indicates that the SPF factor fluctuates, its value has recently been in the area of 25 percent. On this basis, Public Counsel suggests that 25 percent of the costs identified by SWB's dual element cost study be excluded by allocation to the interstate jurisdiction.

The service connection charges proposed under the modified dual element plan would recover an annual amount of $351,000 in disconnection costs. Public Counsel takes the position that no disconnection costs should be included in the establishment of service connection charges. Public Counsel contends that such inclusion results in an improper precollection of disconnection costs by the Company, and suggests that a more appropriate method for recovery of these costs would be either to add a disconnect charge to the customer's final bill or to spread recovery of such costs over the average station life of a standard rotary instrument.

SWB and the Staff are in agreement as to their positions regarding whether interstate costs should be excluded from a service connection cost study and whether disconnection costs should be recovered through the service connection charge. Both of said parties argued that interstate costs should be included and that disconnection costs should be recovered through the service connection charge. Regarding the inclusion of interstate costs in the service connection cost study, both parties point out that the SPF factor utilized in the separations process is an arbitrary percentage which is not specifically cost-based. It is further argued that all service connection costs included in the study are incurred as a result of provision of service to Missouri ratepayers and, therefore, that it would not be appropriate to arbitrarily exclude a portion of the costs so incurred by allocating those costs to the interstate jurisdiction. In regard to the matter of the inclusion of disconnection costs in service connection charges, SWB suggests that significant problems in terms of collection and administration would likely be presented if a disconnection charge were to be included in the customer's final bill, and the Company notes that at present, since there is no separate charge for disconnection, such costs are borne by the general body of ratepayers.

It is recognized that the question as to which cost elements should properly be included in a service connection cost study has been a matter generating considerable and extended debate before this Commission. While it would be desirable to conclusively resolve in this case the questions of whether interstate costs should be included in such studies and whether disconnection costs should be recovered through the service connection charge, the record presented on of both these issues is insufficient upon which to make conclusive judgments. The Commission is not convinced that an allocation of a portion of the service connection cost to the interstate jurisdiction would be proper from a ratemaking standpoint, and even if such an allocation were to be found proper, the Commission is not convinced that the SPF factor is appropriate for calculating such an allocation. Whether disconnection costs should be included in the service connection charge is a matter which requires a full exploration of the various alternatives through which the Company can recover these costs. As noted by SWB, the failure to either include disconnection costs in the service connection charge or to establish a separate charge for service connection costs results in these costs being recovered from the general body of ratepayers.

The Commission is presented with limited alternatives in this case, which appear to be as follows: (1) approve the modified dual element plan submitted jointly by SWB and the Staff; (2) approve SWB's multi-element reprice contained in the Company's original tariff filing in this case; (3) approve the proposal of the Public Counsel through which the rates of the modified dual element plan would be reduced by making an allocation of interstate costs based upon the SPF factor and excluding disconnection costs; or (4) grant no increase in service connection charges and maintain the present multi-element rate design as suggested by MoPIRG.

The Commission concludes that implementation of the modified dual element plan as proposed by SWB and the Staff is the most reasonable option available. While various questions still remain as to the accuracy of the Company's dual element cost methodology, the evidence indicates that the dual element rate design is more specific than its multi-element counterpart in terms of the breakdown of separate cost components. Additionally, the dual element methodology makes a separation between residence and business customers in terms of the S&E cost. Thus, even the modified dual element plan appears to constitute an improvement over the existing multi-element rate design. Since the record is not sufficient to support an allocation of service connection costs between intrastate and interstate jurisdictions, Public Counsel's recommendation does not present a preferred alternative. MoPIRG's position is based primarily on the premise that any increase in service connection charges will reduce the universality of telephone service in Missouri. The Commission finds no evidence in the record to support this premise.

Therefore, based upon the foregoing, the Commission concludes that the modified dual element plan as submitted by SWB and the Staff in Case No. TR-82-14 should be approved. Although the Commission has found this result to be reasonable and supported by competent and substantial evidence in this case, the Commission also believes that the appropriate cost of service study methodology for use in connection with SWB's service connection charges should be determined in advance of SWB's next general rate case. For this purpose, the Commission will by future order open a separate docket. Moreover, since the Commission has determined in this report and order that the continued capitalization of station connection costs is appropriate for ratemaking purposes, SWB should submit, in conjunction with said separate docket or any future proposed increase in service connection charges, a revision to its cost study methodology to reflect the effects of capitalization treatment.

5. <u>Local Measured Service</u>

The local measured service (LMS) concept was initiated in Missouri as an outgrowth of the Commission's decision in Case No. 18,309, wherein SWB was directed to conduct a usage sensitive pricing study for the purpose of determining the reasonableness of usage sensitive pricing of telephone service. As a result of said directive, SWB performed such a study in Springfield, Missouri, which included the variables of time of day, time of week, duration of call and distance. Said study was performed by SWB under the review of the Commission, its Staff, the Public Counsel and certain other intervenors in Case No. TO-78-46. The study was performed during the period May 1978 to April 1979 and resulted in an LMS tariff filing by SWB in April 1980. LMS was approved by the Commission on an experimental basis under which the service was first offered in June 1980. On April 9, 1981, SWB filed tariffs in Case No. TO-78-46 for the purpose of making LMS a permanent service offering in Missouri. By Commission order dated May 14, 1981, Case No. TO-78-46 was consolidated with Case No. TR-81-208, thus including consideration of the Company's LMS proposal within SWB's 1981 general rate case.

Through LMS, the customer receives an access line with unlimited incoming calls. The LMS charge for the access line is lower than that associated with flat rate service. All local messages (outgoing calls) are billed on an occurrence, length of message, distance and time of day basis. The rates for LMS are not based upon a cost study, but were developed for the purpose of making available to customers a relatively low cost form of telephone service where a limited number of outgoing calls are made.

The availability of LMS is limited to areas or exchanges served by Electronic Switching Systems (ESS) with recording arrangement capacity. The Company has limited the availability of LMS to these areas because substantial capital expenditures would be required in order to modify other central offices for LMS capacity. As of June 1981 LMS was available to more than 50 percent of all SWB Missouri customers, and the Company anticipates that LMS will be available to 67 percent of its Missouri customers by the end of this year. SWB presently intends to have the implementation of LMS track the expansion of ESS equipment to central offices. SWB's position is that the decision to install ESS central office equipment is independent of any LMS goals and, instead, is related to needs for the modernization of plant and the expansion of capacity in meeting growth in customer demand.

The LMS data accumulated by Company to date indicates that over 2,700 customers have subscribed to the service and that many of these LMS customers have realized a reduction in their basic local exchange billing as a result of their use of LMS. SWB's data also indicates that approximately 23 percent of present LMS customers are retired and over 65 years of age and that 40 percent of said customers have incomes of less than $10,000 per year. In addition to its request that the Commission make the LMS offering permanent rather than experimental, the LMS tariffs at issue include an increase in rates for the LMS access line, while the LMS usage rates would remain unchanged. The proposed increases in LMS access line rates for the Company's various rate groups are as follows: Rate Groups A and B - 5 cents per month; Rate Group C - 10 cents per month; and Rate Group D - 30 cents per month. LMS access line rates were reduced by these identical amounts subsequent to SWB's most recent Missouri rate case, Case No. TR-80-256. These reductions in LMS access line rates tracked reductions in local exchange rates for those rate groups which occurred as a result of the Commission's order in Case No. TR-80-256. Therefore, by its LMS filing in this case, SWB proposes to restore the level of LMS rates established under the LMS experimental service offering in June 1980.

In conjunction with its proposal to make LMS a permanent service offering and to increase the LMS access line rates as specified above, SWB seeks authorization to restrict the availability of its 1MR and 1MB services. Said services are one-party message rate offerings for residence and business customers, respectively. The 1MR service includes a one-party line and unlimited incoming calling. Additionally, the 1MR customer is entitled to 20 local outgoing calls, with each call in excess of 20 per month being billed at 10 cents per call. The calls are neither timed nor are distance sensitive. The 1MB service is a similar offering for business customers. The 1MR service is experimental and is currently offered by the Company only in four wire centers, those being: Sedalia, Caruthersville, and the Forrest and Mission wire centers in St. Louis. Under the Company's proposal, the 1MR service would be withdrawn in the Forrest and Mission wire centers since LMS is currently offered there, and subscribers to 1MR in those locations would have the option to switch to LMS service, or any other available service, with no service connection charges applying. In Sedalia and Caruthersville, where LMS is not yet available, existing customers would be able to retain their 1MR service at existing locations until LMS becomes available. However, SWB would not provide 1MR service to new customers or to existing customers moving to new locations in Sedalia or Caruthersville. SWB's proposal would obsolete 1MB service to existing customers at existing locations where LMS is available. At locations where LMS is not available and 1MB is currently available, the Company would continue to offer 1MB to new customers. Unlike the experimental status of 1MR, 1MB is a permanent service offering which has been available to Missouri customers for over 50 years.

As indicated in the Hearing Memorandum (Exhibit 3), the Staff supports SWB's request to make LMS a permanent service offering in Missouri. Public Counsel opposes the Company's LMS proposal and suggests that the Commission approve a revised message rate tariff which differs in various respects from the Company's LMS offering. MoPIRG opposes Commission approval of SWB's LMS offering at this time, and suggests that the Commission require SWB to perform a cost study to determine appropriate rate levels for the LMS variables.

As indicated previously, the message rate element (as opposed to the access line rate) is a function of four factors under SWB's LMS proposal. These factors are occurrence, length of message, distance and time of day. Public Counsel's position, as stated by witness Johnson, is that the cost of a local call is primarily a function of occurrence and not duration, distance or time of day. Thus, Public Counsel contends that the Company's use of four factors in determining the message rate under LMS is unnecessarily complex and will inhibit customer understanding of the LMS service offering. Public Counsel also characterizes LMS as being part of an effort by the Bell System to artificially increase local exchange flat rates and to mitigate unfavorable reaction to such increases by offering LMS at relatively low rates.

Public Counsel suggests that the Commission adopt a message rate tariff which would include the following elements: (1) all message rates would include a monthly access line charge which is about 50 percent of the corresponding monthly flat rate for each rate group; (2) the charge per call would be uniform among all of the message rates; (3) the monthly call allowance for 1MR service would be increased from 20 to 40 calls; and (4) the monthly call allowances for 1MB and measured trunk service would be decreased to 80 and 160 calls per month, respectively.

MoPIRG's opposition to LMS is based upon the supposition that the Company's proposal to make LMS a permanent offering in Missouri is merely a first step in the implementation of universal, mandatory local measured service.

The data gathered by SWB regarding the experimental implementation of LMS in Missouri supports a finding that LMS provides a low-cost basic service option which may be attractive to various of the Company's customers. Numerous combinations are possible in terms of the factors considered in calculating the message portion of an LMS rate. While the use of a single message rate factor would result in a simpler LMS bill, it cannot be concluded from the evidence before us that the use of four message rate factors produces an LMS bill which is unduly complex. Neither is it clear that the other revisions proposed by Public Counsel to the Company's LMS proposal would constitute improvements upon the Company's plan. As to the contention that institution of LMS on a permanent basis is a first step toward mandatory, universal local measured service and an artificial increase of local exchange flat rates, it hardly needs to be emphasized that the LMS proposal before the Commission would merely grant permanent, as opposed to experimental, status to the offering. LMS would be optional rather than mandatory. Additionally, any proposals by SWB for the increase of local exchange flat rates is evaluated on the merits of the issue, and determination of same is not dependent upon whether LMS is a permanent service offering.

Therefore, based upon the record presented, the Commission is of the opinion that SWB's request to make LMS a permanent service offering in Missouri should be granted. Additionally, the increases proposed by the Company for the LMS access line charge are reasonable in the context that local exchange flat rates will be increased as the result of this report and order. However, the Commission is of the opinion that the Company should conduct a cost study regarding the provision of LMS, and for this purpose Case No. TO-78-46 shall remain open. The Company is directed to file, within sixty (60) days in that docket, a proposal for implementing such a cost study.

The Commission does not find it appropriate to approve SWB's proposals which would restrict the 1MR and 1MB service offerings. The Commission finds the evidence insufficient to determine whether LMS will adequately meet the needs of customers presently utilizing the 1MR and 1MB services. Additionally, SWB has not established that the continued provision of 1MR and 1MB service would result in placing an undue burden upon the Company. Therefore, SWB's proposal to obsolete 1MB service to existing customers at existing locations where LMS is available is denied, and the Company's proposal to withdraw 1MR service in the Forrest and Mission wire centers in St. Louis and to obsolete said service except for existing customers at existing locations in Sedalia and Caruthersville is also denied.

6. Deferred Installation Payment

The Company proposes in this proceeding to reduce the time its customers are allowed to defer payment of installation charges from the current period of twelve months to four months. The Staff supports the Company's proposal and MoPIRG is the only party to voice opposition to the proposed reduction of the installment billing period.

SWB considers the requirement that it provide a twelve-month interest-free period for customer payment of installation charges to be unreasonable, unnecessary and unsound from a business standpoint. The cost involved in providing an extended period for payment of installation charges must be borne by the general body of ratepayers. As the Company notes, it is the only telephone company in Missouri required to allow its customers to defer payment of installation charges. The position taken by MoPIRG implies that continuation of the twelve-month deferred payment period for installation charges is essential to the promotion of the goal of universal service. The Commission does not agree with this argument. The Commission finds that a four-month deferred payment period is reasonable, particularly when it is considered that residential customers generally have the option of reducing their service connection charges through participation at a Phone Center Store. The Commission is of the opinion that a four-month deferred payment period for installation charges would constitute an appropriate balance between the needs of customers in making payment of installation charges and the avoidance of placing unreasonable costs on the general body of ratepayers through an unduly extended deferral period. Therefore, the Commission concludes that SWB's proposed reduction of the deferred billing period for installation charges is reasonable and should be granted.

Conclusions

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

SWB 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 to, among other things, 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 rates shall be fair, just, 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 SWB in Case Nos. TR-81-208, TR-82-14 and TO-78-46 should be disallowed, and SWB should be authorized to file revised tariffs in conformance with the findings of this Report and Order. Also in conformance with this Report and Order, SWB's Local Measured Service offering should be made permanent.

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.

It is, therefore,

ORDERED: 1: That the revised tariffs filed by Southwestern Bell Telephone Company in Case Nos. TR-81-208, TR-82-14 and TO-78-46 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 revenues by approximately $88,286,000.00, exclusive of gross receipts and franchise taxes, and said revised tariffs shall be in conformance with the rate design and other findings contained in this Report and Order.

ORDERED: 2. That Southwestern Bell Telephone Company's Local Measured Service offering shall be made permanent.

ORDERED: 3. That Case No. TO-78-46 shall remain open for the purposes set forth in this report and order.

ORDERED: 4. That the rates to be established through revised tariffs conforming to the Commission's findings in this Report and Order may be effective for service rendered on and after December 9, 1981.

ORDERED: 5. That this Report and Order shall become effective on the 9th day of December, 1981.

BY THE COMMISSION

Harvey G. Hubbs

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,
R.S.Mo. 1978.
Musgrave, C., Not Participating.

Dated at Jefferson City, Missouri,
on this 27th day of November, 1981.