BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

The Staff of the Missouri Public Service Commission, Complainant, v. Southwestern Bell Telephone Company, a Missouri corporation, Respondent.	)	Case No. TC-93-224
In the matter of proposals to establish an alternate regulation plan for Southwestern Bell Telephone Company.	)	Case No. TO-93-192

REPORT AND ORDER

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HEARING EXAMINERS: Cecil I. Wright, Elaine E. Bensavage.

REPORT AND ORDER

In an order issued December 18, 1992, Case No. TO-92-192 was established by the Commission in response to a motion filed by the parties in Case No. TO-90-1. Case No. TO-93-192 was established to consider future alternative regulation proposals for Southwestern Bell Telephone Company (SWB). The Commission also adopted a procedural schedule which set prefiling dates and hearing dates.

On January 15, 1993, Commission Staff filed a complaint against SWB in which Staff alleged that SWB's rates, under traditional ratemaking methods, produce an excessive level of earnings in the range from $100 million to $150 million per year. In an order issued January 20, 1993, the Commission gave notice to SWB of the complaint. Staff stated it based its findings on a test year of calendar year 1991 updated through September 30, 1992. The Commission ordered SWB to either satisfy the complaint or file an answer, to either agree with Staff's test year or recommend a different one, and issued a Protective Order for protection of information considered confidential.

Staff prefiled its testimony in support of its complaint on February 1, 1993. SWB filed its answer as required on February 23, 1993, and its recommendation concerning a test year. In its answer, SWB denied its earnings were excessive and suggested the Commission should analyze its operations under the experimental incentive regulation plan adopted in Case No. TO-90-1 instead of an historical test year as proposed by Staff's complaint. SWB also raised several affirmative defenses in its answer.

The Commission, after reviewing Staff's complaint and SWB's answer, found that there were factual issues that could only be resolved after hearing and so set the complaint for hearing on the same procedural schedule as Case No. TO-93-192, as modified. The Commission also adopted Staff's test year.

Interested persons were granted intervention in one case or the other, or both cases. Since Case No. TO-93-192 and Case No. TC-93-224 were consolidated by Commission order issued April 13, 1993, parties became parties to both cases.

Intervention was granted to: MCI Telecommunications Corporation (MCI); Midwest Independent Coin Payphone Association (MICPA); AT&T Communications of the Southwest, Inc. (AT&T); United Telephone Company of Missouri (United); Competitive Telecommunications Association of Missouri (CompTel); Alma Telephone Company; Northwest Missouri Rural Telephone Company; Mid-Missouri Telephone Company; Chariton Valley Telephone Corporation; Choctaw Telephone Company; MoKan Dial, Inc.; Peace Valley Telephone Company; Missouri Cable Television Association (MCTA); GTE North Incorporated, GTE Missouri, GTE of Eastern Missouri and GTE Systems of Missouri (now GTE Midwest Incorporated) (GTE); United States Department of Defense and All Other Federal Executive Agencies (DOD); Bourbeuse Telephone Company, Citizens Telephone Company of Higginsville, Missouri, Inc., Craw-Kan Telephone Cooperative, Inc., Fidelity Telephone Company, Granby Telephone Company, Grand River Mutual Telephone Corporation, Green Hills Telephone Corporation, Holway Telephone Company, KLM Telephone Company, Kingdom Telephone Company, Lathrop Telephone Company, McDonald County Telephone Company, Mark Twain Rural Telephone Company, Miller Telephone Company, New London Telephone Company, Orchard Farm Telephone Company, Oregon Farmers Mutual Telephone Company, Steelville Telephone Exchange, Inc., Stoutland Telephone Company and Wheeling Telephone Company; State of Missouri, at the relation of Jeremiah W. (Jay) Nixon, Attorney General of Missouri (Attorney General); ALLTEL Missouri, Inc., Eastern Missouri Telephone Company and Missouri Telephone Company (collectively, ALLTEL); Communications Workers of America, AFL-CIO, CLC (CWA); Missouri Alliance of Area Agencies on Aging, Missouri Association of Senior Center Administrators, Missouri Association for the Deaf, and the Missouri Council for the Blind (collectively, Intervenors for Independent Options); CyberTel Cellular Corporation (CyberTel);

McCaw Cellular Communications, Inc. (McCaw); and ALLTEL Mobile Communications of Missouri, Inc. (ALLTEL Mobile). Participation without intervention was granted to: Regional Consortium for Education Technology--Southwest; Freeman Hospital; Economic Development Corporation of Jefferson County, Missouri; Missouri Industrial Development Council, Associated Industries of Missouri, Missouri Community Betterment Education Fund, Fredericktown Chamber of Commerce, Farmington Industrial Development Authority, and Southwest Missouri Office on Aging; Jefferson Memorial Hospital Association; St. Louis County League of Chambers of Commerce; and Carroll County Department of Economic Development, Adrian R-3 School District, and City of Nixa, Missouri.

The hearing was held as scheduled from July 12 to 16 and 19 to 23, 1993, and August 2 and 3, 1993. Parties filed briefs and the two cases are now before the Commission for consideration.

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.

The two consolidated cases had their genesis in Case No. TO-90-1. In that case the Commission approved an experimental incentive regulation plan for SWB. The plan was to last three years and included a revenue sharing grid based upon SWB's return on equity (ROE) for each year. Earnings above a certain ROE were to be shared between SWB and its customers by a credit each year on each customer's bill. The experimental plan was the result of a settlement of the appeal of consolidated cases referred to collectively as Case No. TC-89-14. Re: Staff v. Southwestern Bell Telephone Company (SWB), 29 Mo. P.S.C. (N.S.) 607 (1989). The calculations under the incentive plan concerning SWB's return on equity (ROE) were based upon the Report And Order in Case No. TC-89-14 and monitoring procedures agreed to in the settlement. The settlement, though, reduced the revenue reduction of $101 million ordered in Case No. TC-89-14 to $82 million and allowed SWB to retain earnings which resulted from an ROE of 14.1 percent and below rather than the 12.61 percent found to be reasonable by the Commission.

As part of the agreement in Case No. TO-90-1, Staff, SWB, and the Office of Public Counsel (OPC) filed reports in October 1992 concerning the success of the experimental incentive plan. One of the recommendations in those reports was to create a docket to consider whether a future plan was appropriate. Case No. TO-93-192 was established for that purpose. The experimental incentive plan was then extended to January 1, 1994, so there would be no lapse in plans if the Commission adopted an alternative regulation plan for SWB. As part of Staff's evaluation of the success of the experimental plan, it conducted an audit concerning SWB's earnings levels. The audit resulted in the complaint filed by Staff which is Case No. TC-93-224.

SWB has raised the issue of whether Staff had explicit authority to bring its complaint under the provisions of Section 386.390.1, R.S.Mo. 1986. The Commission believes Staff has sufficient authority to file its complaint and that the Commission, by giving notice and ordering an answer, authorized the complaint. The Commission also believes that Staff had authority to conduct its audit and that implicit in that authority was the authorization to file a complaint if the audit results indicated such a course of action was appropriate. Either of these actions complies with the requirements of Section 386.390.1. In addition, Staff has historically been delegated authority, pursuant to Section 386.240, R.S.Mo. 1986, to monitor the operations of regulated companies and has been given the general authority to file a complaint concerning those operations, including one alleging excessive earnings, if it determines such a complaint is warranted. Whether the complaint is supported by the evidence is the subject of this proceeding, and no action based upon Staff's complaint is required of SWB until the Commission issues this Report And Order.

SWB's main defense to the complaint is that the experimental incentive regulation plan has been successful and the Commission should authorize SWB to continue under a similar plan without a traditional earnings investigation. SWB argues that rates have been reduced or have remained stable, service has been good, investment in Missouri infrastructure has been accelerated, and customers have shared in a portion of the company's earnings. SWB argues that the plan has been a success and a return to traditional regulation would be a step backward for the company and Missouri ratepayers.

SWB proposes that instead of considering Staff's allegations concerning excessive earnings based upon traditional rate base ratemaking, that the Commission approve SWB's proposal for alternative regulation. This proposal would reduce rates by $22 million per year, expend Lifeline service and make additional investments in facilities of approximately $82 million over the next three years. The network expansion as originally proposed would include DS-3 fiber optic infrastructure for its service territory and connect all interested public middle schools, high schools, colleges and hospitals so that Distance Learning and TeleMedicine could be provided throughout SWB's service territory. This proposal was expanded at the hearing.

The Commission will consider SWB's alternative regulation proposal, as well as the proposals or positions of the other parties, in a later section of this Report And Order. The Commission finds, though, that it cannot simply move from the experimental incentive regulation plan to an alternative regulation plan without first considering the level of SWB's earnings. Traditional regulatory principles provide the underpinning of the statutory obligation of the Commission to ensure that rates are just and reasonable. Without consideration of Staff's allegations, and those of other parties, concerning the excessive level of SWB's revenues, the Commission cannot make a reasoned decision concerning alternative regulation for SWB.

The three-year experimental plan was just that: an experiment. The Commission believes that the plan was a success since it allowed SWB to operate within a different regulatory framework and to accomplish some necessary goals for SWB consumers. There is no question that sharing did occur during the plan, sharing that might not have occurred under traditional regulation due to regulatory lag and other constraints on Commission resources. There is no question that part of the agreement establishing the plan included a specific modernization proposal which has upgraded a substantial portion of SWB's network. This may or may not have occurred without the specific agreements in the plan, but there is no question that it did occur as a specific requirement of the experimental plan.

The experiment, though, has ended and any decision now to approve a permanent plan must be made after a review of SWB's existing rates to ensure that a permanent plan, if approved, will be based upon the statutory requirement of just and reasonable rates. The rates now in effect were set based upon an agreed-to revenue requirement after the Commission's Report And Order in TC-89-14 was appealed. The revenue level is not the result of a Commission Report And Order. Over the three-plus years since those rates were set, financial conditions and SWB's operations have changed. The Commission finds that those changes necessitate a consideration of SWB's revenue requirement under traditional ratemaking before any consideration of an alternative regulation plan can be made.

<u>Test Year</u>

The Commission in its March 9, 1991, order discussed the issue of which test year to use in the complaint case and adopted a test year of calendar year

1991 as updated through September 30, 1992. SWB had argued for a test year utilizing the twelve months ending September 30, 1992, which would then be brought to year-end 1992 and pro forma adjustments made for known and measurable changes.

The Commission rejected SWB's proposed test year, recognizing that adopting SWB's test year would require Staff to update its entire audit and thus delay the case. The Commission in recent years has been bombarded by test year issues as companies and Staff jockey for position in presenting their revenue calculations to the Commission. The Commission, though, in this case reiterated its position on the purpose of a test year and how adjustments to a test year should be made.

As stated in its March 9 order, a test year is a starting point from which all parties' cases must begin so that their cases can be reconciled when the case is submitted to the Commission for decision. This test year results in a matching of all components of SWB's revenue requirement. The Commission requires this initial matching so that it will not fall victim to a case in which the parties' cases were unreconcilable. For a party's evidence to be considered in a case, it must be based upon the test year adopted by the Commission for the case.

Proposals can be made to adjust the test year numbers. The updated period recognizes this and allows the parties to update their cases to a date closer to the hearing if significant changes have occurred affecting the levels of an item. This update is not for all accounts. Annualizations and normalizations may be performed on test year data in an attempt to find what is a reasonable level of expenses, investment or revenues. Parties may also seek isolated adjustments beyond the test year as updated if they believe significant changes have occurred which are sufficiently known and measurable and which will not unreasonably distort the matching of investment, expenses and revenues developed using the test year and any update.

In this case both SWB and Staff have annualized, normalized and proposed other adjustments to test year levels. Many of the differences in whether and how to annualize, whether to update, or whether to make an isolated adjustment, will be decided in this Report And Order. Both parties, though, have seemingly become strident about their claims that the other party has not adjusted test year data appropriately and therefore the matching of expenses, investment and revenues has not been maintained.

The Commission has come to expect the increased adversarial nature of test year related issues. The stakes are high, especially in this case. The Commission, though, hopes that through a consistent approach to most test year issues parties will again return to substantive discussion of the issues rather than hammering endlessly on the anvil of matching of revenues, rate base and expenses, as if by sheer force the case can be molded into the desired form.

Since there is no dollar adjustment related to this issue, the Commission will save further discussion for those issues which involve disputes as to the proper period upon which to base any adjustment concerning an item in SWB's revenue requirement calculations.

Annualization/Year Ending

A. Revenues

Staff and SWB have proposed levels of revenues which each contends are the appropriate levels for consideration in determining whether SWB is overearning. Both Staff and SWB used the same marketing report to analyze revenues and upon which to calculate their annualization adjustments. The marketing report identifies the actual monthly revenue for each product. The report prices out the number of units sold in each month, assuming a full month of billing for each service provided at the end of the month.

The difference between Staff's and SWB's calculation is a clear example of the issues generated by adjusting test year data. Both Staff and SWB propose to bring the test year 1991 level of revenues forward to September 1992. Staff, for most of the revenue categories, used the September 1992 levels and multiplied those by twelve to obtain an annual level. For those categories of service where Staff did not believe the September 1992 revenue level was representative, Staff used either the average of the nine months ending September 1992 times twelve or the test year 1991 levels.

SWB opposed certain of Staff's annualizations based upon what it considered the nature of the revenues. SWB found four areas it considered significant and proposed a different calculation for those areas. The four calculations propose to recognize (1) the seasonal nature of both access and toll revenues, (2) nonrecurring local revenue and end user revenues, (3) full twelve-month data when no trend was discernible, and (4) the use of the current average rate to estimate the level of uncollectible revenue.

Revenues, as with all components of the calculation of a regulated company's revenue requirement, must be analyzed to determine what is the proper level for establishing just and reasonable rates for the period when those rates will be in effect. Rarely are test year levels adopted without some adjustment, and in this case neither party proposes using total test year levels as the appropriate level for this case.

Both Staff and SWB analyzed the revenue accounts and proposed different calculations for establishing revenues for different accounts. The difference in the two approaches is epitomized by the different descriptions of the issues as set out in the Reconciliation, Exhibit 204. Staff described the contested issues by account, i.e., local service revenues, toll revenues, access revenues, other revenues, and uncollectibles. SWB described the contested issues by category, i.e., seasonal (access, toll), nonrecurring (local, access), test period (local, toll, other), and uncollectibles.

For access and toll revenues the basic difference between the two positions is that Staff considered SWB's revenues to be increasing and therefore considered the September 1992 levels representative of ongoing revenue growth. SWB considered access and toll revenues to be fluctuating over the twelve months ending September 1992 and so it proposed to use an average of the twelve months as the basis for its annualized calculation. Both took their monthly levels times twelve to arrive at their total revenues for these services.

The Commission finds that Staff's method of annualizing access and toll revenues is more reasonable. Where the trends show that revenues are increasing over the twelve-month period or from year to year, using the final month times twelve is more appropriate than an average. Even though the evidence indicates monthly access and toll revenues fluctuate, a twelve-month average is not appropriate where there is a general trend showing an increase in revenues. Staff's method thus is more reflective of the level of revenues SWB will experience when the rates set in this case will go into effect.

The evidence did indicate that as actual revenues are recorded on SWB's books, Staff's revenue calculations are clearly more reflective of ongoing operations. Staff's use of various analyses to verify that revenues were increasing, as described by Staff witness Becker, reflects the more thorough analysis of the revenues and the more reasonable method of discerning if the trends reflected by the revenue data are constant.

SWB's fallback argument, which asserts that all expenses must be brought forward if revenues are based upon September 1992 levels, is a rather shallow reliance on the matching principle. If SWB truly believed matching was the key to the development of a reasonable revenue requirement, it would not annualize, normalize, or propose isolated adjustments beyond the test year for revenues or other items; it would take all levels at September 1992. Once it is determined that adjustments should be made, then the issue becomes which method better reflects ongoing levels.

The difference between Staff's and SWB's calculations of nonrecurring and end user access revenues results from the same methods used to calculate access and toll revenues. Staff uses September 1992 times twelve, while SWB uses an average of the twelve months ending September 1992 times twelve. Staff's analysis shows that nonrecurring revenues are increasing, while end user access local service revenues are stable. SWB claims September is a high volume month and so Staff's method overstates SWB's revenues for these services.

The Commission finds the evidence supports Staff's annualization. Where trends are discernible, the final month times twelve is a more appropriate method than an average of the twelve months. Here, local service nonrecurring revenues are shown to be increasing while end user access nonrecurring revenues are stable. For increasing or stable revenue levels, end of period times twelve is the more appropriate of the two methods presented.

The Commission would point out that the revenue calculation is not an attempt to establish the actual revenues to be generated, but is to reflect a reasonable level of revenues for establishing just and reasonable rates for the period over which those rates will be in effect. If total revenues calculated for determining a revenue requirement are then exceeded by actual revenues in the near future, as the evidence indicates is the result for SWB, it is reasonable to conclude the revenues were set at an appropriate level.

For revenue accounts where there was no discernible trend, Staff used 1991 data or a nine-month average ending September 1992 times twelve. SWB used the total revenues for the twelve months ending September 1992. The categories where the different calculations occur are: (1) Primary Toll Carrier revenue retained by SWB; (2) settlements with other LECs for expanded area service, (3) settlements with other companies related to credit card, (4) third number billing, and (5) White Pages directory revenues.

The different methods for calculating revenues in these categories again demonstrate the differences which can occur when test year results are adjusted. SWB has brought the test year forward to September 1992 and claims that this best represents its ongoing level of revenues. This, SWB contends, also retains the matching of revenues to expense and rate base.

The Commission finds that Staff's methods of calculating revenues for those categories where no discernible trend is apparent is the more reasonable. Merely moving the test year forward to September 1992, as SWB has done, does not reflect any consideration of what Staff found in analyzing the revenues in these categories. Staff found that these product lines exhibited large monthly fluctuations or included negative balances throughout the period analyzed. The use of test year 1991 levels is consistent with the test year adopted in this case and an average for nine months times twelve removed the anomalies of negative balances and is more reflective of ongoing operations than September 1992 times twelve. The average of nine months resulted in a conservative level of revenues since the debit balances were included in the average.

Taking Staff's revenue calculations for these categories and comparing them to the actual revenues again reflects that Staff's total revenue calculation is reasonable and representative of SWB's operations on an ongoing basis. If the Commission were to adopt SWB's arguments concerning matching, there would be few adjustments to the test year since all parts of the revenue requirement should remain in lockstep. Matching is a genuine concern when isolated adjustments outside the test year are proposed and considered. Isolated adjustments, though, are proposed and are, on occasion, adopted without matching. Adjustments in test year data or a test year as updated are made to develop a revenue requirement for a company for a period when the rates will go into effect. Adjustments to test year data are always made to reflect ongoing operations as closely as possible. Matching in a case will not necessarily result in all data being brought to a certain date, but will result in any changes to test year levels being supported by the record. Matching means that expense, revenue and investment levels are adjusted in such a manner that they maintain their relationship in calculating an overall revenue requirement. The resulting revenue requirement should reflect ongoing operations.

The final contested matter in this issue is uncollectibles. The Commission finds that uncollectibles should be set at the level proposed by Staff. Based upon the reconciliation, SWB appears to be in agreement.

B. Nonwage Expenses

Nonwage expense items are described as those expenses not considered wage expense. Although the description is not very definitive, these types of expenses include office supplies, gasoline, advertising, paper products, computer software, Health Maintenance Organization payments, other health care payments for vision and dental care, allocations from Southwestern Bell Corporation, depreciation, Right-To-Use fees and rent. SWB witness Wupfer states that she has updated the nonwage items (SBC allocations, Right-To-Use fees, affiliate transactions, advertising, business meals, benefits, and other) through September 1992. This, she contends, provides a proper matching of expenses and other items updated to September 1992 such as other wages and salaries. Wupfer then proposes to adjust these items, except for Right-To-Use fees and affiliate transactions, using the Gross National Product-Implicit Price Deflator (GNP-IPD). This, SWB contends, accounts for the overall price behavior for all goods and services in the economy and should be reflected in determining the level of nonwage expenses.

Staff in its case reflected test year 1991 levels of expense for those items and did not update them to September 1992. Staff opposes the update on the basis that SWB has not shown why expenses increased to the September 1992 levels and failed to demonstrate that these levels are more reflective of SWB's ongoing operations. Staff opposes the GNP-IPD adjustment as not known and measurable and as merely an adjustment for inflation which the Commission has regularly rejected.

The Commission has considered SWB's proposed adjustments to test year levels and finds they are not appropriate. SWB's argument that these nonwage expenses must be brought forward to maintain a proper matching ignores the test year. A test year of calendar year 1991 was set in this case and updates were approved for items where significant changes occurred. SWB has made the argument consistently that all items should be brought forward. This, though, would move the test year and would require Staff to reaudit all of the company's operations through September 1992. In addition, bringing these levels forward might not establish appropriate levels of expense for these items.

If the Commission adopts SWB's position on updating without requiring some evidence of significant changes associated with the updated items, it will have in effect moved the test year. Updates are allowed to more closely reflect ongoing operations, especially for major items which traditionally change, such as wages and salaries. The logical extension of SWB's argument is to not allow any update period and maintain a rigid adherence to test year data. This would not be reasonable, nor would it properly reflect SWB's ongoing operations.

The Commission finds for nonwage expenses that the evidence is not convincing that September 1992 levels are representative of ongoing operations. Significantly, SWB has been downsizing its operations, reducing its overall costs and reorganizing. All of these efforts to make its operations more efficient indicate that 1991 levels may be too high for nonwage expenses.

Additionally, the Commission views the proposal to adjust nonwage items for the GNP-IPD as an inflation adjustment. The evidence is not convincing that this type of national indicator reflects what has actually occurred concerning SWB nonwage expenses. The Commission has traditionally rejected these types of adjustments as not known and measurable and not company-specific. The Commission finds that the evidence in this case is lacking to show a direct relationship with SWB's current operations and the GNP-IPD. The study testified to by Wepfer was a 1988-1989 study. The use of a more recent study to show a relationship between GNP-IPD or any other indicator and SWB nonwage expenses would be necessary for the Commission to consider such an adjustment.

The update to affiliate transactions was treated as a separate subissue in this case. The evidence indicates that the increase in expense level of the update period over the test year period is due to a nonrecurring event that has already been completely paid through the 1992 credit calculation. SWB did not brief this issue. The Commission finds that Staff's position is supported by the record.

C. <u>Access/Billing and Collection Expense</u>

In its reply brief, Staff conceded that "access charge units as an expense item directly relate to units to toll that produce revenues." Staff then agreed to SWB's proposed adjustment if the Commission adopts Staff's revenue annualization. Since the Commission adopts Staff's revenue annualization, it will adopt SWB's adjustment for access expense.

D. <u>Deregulated Services - Test Year</u>

SWB provides both regulated and deregulated services in its operations. The revenues, expenses and investment associated with providing deregulated services must be removed from the cost of service calculations in this case so that only regulated operations are reflected in SWB's revenue requirement. Both Staff and SWB agree on this matter and they also agree that SWB's Cost Allocation Manual (CAM) should be used to establish the deregulated services adjustment. The contested issue regarding deregulated services is what period should be used to determine the deregulated services adjustment. Staff proposes using test year 1991 data while SWB proposes using the twelve months ending September 1992.

The Commission finds that test year 1991 data should be used for determining the deregulated services adjustment. Even though both parties use CAM results, it appears from the record that Staff was able to audit the 1991 data and the external auditor's report concerning that data. This is not true for the CAM results for the twelve months ending September 1992.

Work papers of the external auditor were not provided to Staff until June 14, 1993, which made it impossible for Staff to audit those work papers in preparation for the hearings in July 1993. In addition, SWB does not offer sufficient evidence of the reason for the decrease in costs for deregulated services as reflected by the CAM results for the twelve months ending September 1992. An explanation for the CAM changes or evidence which reflects that the twelve months ending September 30, 1992 is more reflective of ongoing operations, is necessary for the Commission to find that updating the test year level of expenses is appropriate.

E. Separations

Allocations are made between SWB's interstate operations and Missouri jurisdictional operations based upon separations factors. All issues concerning separations have been resolved except the issue of whether to include a March 1993 Federal Communications Commission (FCC) decision requiring the direct assignment of billing and collection charges paid by SWB to other local exchange companies for intraLATA toll. In March, the FCC issued its opinion clarifying an earlier Common Carrier Bureau Letter of Interpretation issued August 21, 1991. SWB proposes to reflect the FCC opinion in this case while Staff opposes it as an out-of-period adjustment.

The evidence indicates that until the Letter of Interpretation, SWB payments to other LECs under the Primary Toll Carrier (PTC) plan were directly assigned to intrastate operations. The Letter of Interpretation indicated this 100 percent assignment to intrastate might not be proper. After the Letter of Interpretation in August 1991, SWB changed the direct assignment of these costs and allocated costs using separations factors. The March 1993 FCC opinion reinstated the direct assignment of these costs, finding they were uniquely identified with intrastate operations. The opinion was to be applied retroactively to August 1991.

Based upon the history of this matter, the Commission finds that this change is appropriate to be included in this case. This is an isolated adjustment that was pending during the case. Also, the retroactive application of this change makes it appropriate to include the costs in the revenue requirement calculations in this case even though it is outside the test year and updated period.

Senate Bill 380

In May 1993 the Missouri General Assembly passed and the Governor signed Senate Bill 380, sometimes referred to as the "Outstanding Schools Act". Two changes in taxes were included in the legislation that will increase the amount of property and income taxes paid by SWB. Property taxes will increase if school districts decide to increase their levies to $2.75 for the tax year beginning January 1, 1994. School districts must increase their levies to this level to be eligible for additional state funding. Income taxes will be increased from 5 percent to 6.25 percent and the federal income tax deduction used in calculating Missouri taxable income will be reduced from 100 percent to 80 percent. In its initial brief Staff states that it opposes the adjustments. The brief, though, focuses primarily on the property tax issue.

The Commission finds that the adjustment proposed by SWB for the income tax increase which results from the enactment of Senate Bill 380 is an appropriate isolated adjustment to the test year. This tax increase is the result of government actions and is directly related to the amount of income SWB earns. Staff witness Schallenberg testified that the actual income tax increase can be calculated once a decision is reached in this case. The Commission finds that this adjustment is therefore sufficiently known and measurable to include in this case.

The Commission finds that the property tax expense increase is not subject to the same calculation as the income tax increase and is not known and measurable. The amount of increase will be dependent on the action of independent school districts and will occur almost two years outside the test year or the updated period. There is too much uncertainty in the calculation of this adjustment and the inclusion in this case is not appropriate.

Right-To-Use Fees

Right-To-Use (RTU) fees and License-To-Use (LTU) fees are payments to vendors for use of the vendor's software to operate computers. Examples of the software are Disk Operating System (DOS), Multiple Vertical Storage (MVS) and Lotus spreadsheet software. These fees are normally associated with personal computers and minicomputers, as well as mainframe computers. SWB uses the software to operate network equipment such as switching equipment.

Staff has included test year 1991 levels of RTU fees and LTU fees in its case. SWB has updated the level of RTU and LTU expense to what it considers an ongoing level. SWB recognizes that the 1992 levels of this expense are due to nonrecurring events. SWB, though, proposes to recover the difference between actual RTU/LTU fees for 1992 and the ongoing level by amortizing the difference over three years.

The abnormally high levels of RTU/LTU fees in 1992 were due to an FCC order regarding provisioning of 800 database access service and a modification in the terms of SWB's contract with AT&T for the provisioning of CCS7-CCO (Common Channel Signaling Seven-Connecting Central Offices). SWB proposes to amortize the excess of these fees because they are the result of an FCC order and the change in the CCS7-CCO contract. SWB contends these expenses are properly incurred and should be recovered. Rather than recovering the expenses at one time, SWB proposes to recover them over three years to coincide with the period of the proposed alternative regulation plan.

Staff opposes the amortization. Staff states that the RTU fees were considered in the 1992 credit calculation and to allow amortization would allow double recovery. At hearing, SWB conceded this issue and withdrew the testimony supporting the amortization of the RTU/LTU fees from 1992. Staff claims in its reply brief that SWB has failed to address the RTU/LTU nonwage expense issue and therefore has conceded that subissue also. Although SWB does not address the subissue in its initial brief, it does address it in its reply brief.

The Commission is not completely clear whether the issue concerning the proper level of RTU/LTU fees to use in this case is a subissue of the amortization issue or a subissue of the nonwage expense issue. SWB witness Wupfer includes it in her nonwage discussion and calculation and then refers to SWB witness Martin's testimony. Martin's testimony, though, relates almost completely to the amortization issue.

Irrespective of where the issue should properly be addressed, the Commission will address the issue here. Based upon the evidence that SWB proposes a projected level of RTU/LTU fees, the Commission finds that Staff's position is more reasonable. SWB proposes the use of projected 1993 RTU/LTU fees which are not known and measurable and will not be known and measurable until SWB's 1993 books are completed. In addition, the evidence shows that the test year 1991 levels are representative of RTU fees on an ongoing basis and SWB has failed to support the increase projected for LTU fees. Without proper justification, the Commission does not believe use of projected data is appropriate.

This proposed adjustment shows how inconsistent SWB is in its repeated assertion that every item should be brought forward to the updated period. Clearly the September 1992 levels of RTU/LTU expense are not representative of ongoing levels. SWB recognizes this and proposes an isolated out-of-period adjustment. The proposal to make an isolated adjustment is not improper but the fact that SWB makes such a proposal belies the resounding echo of the "matching" song heard on other issues.

Kansas City Data Center

The Kansas City Data Center has operated on a stand-alone basis since 1983 when Missouri data processing operations were moved to the St. Louis Data Center. The Kansas City Data Center now provides processing applications for other entities, such as other Regional Bell Operating Companies. Work is done at the Center under contract for Bellcore as well as for non-SWB related customers. SWB in 1992 determined that most of the work done at the Kansas City Data Center should be classified as nonregulated and SWB changed its operations beginning January 1993 to reflect that classification.

Based upon its decision to treat the Kansas City Data Center operations as nonregulated beginning in 1993, SWB proposes an out-of-period adjustment to reflect the removal from the regulated cost of service, the expenses, revenues and investment for the Missouri jurisdiction. Staff proposes to reflect the Kansas City Data Center operations at September 1992 levels.

The Commission finds that it is premature to remove the Kansas City Data Center from Missouri cost of service. The CAM used to calculate the deregulated expenses needs a full year of operations data to properly calculate any adjustment. Without the CAM results, this adjustment is not known and measurable and is outside the test year as updated. Adjustments based upon CAM results audited by Commission Staff are necessary before an adjustment for removal of the Kansas City Data Center from Missouri jurisdiction can be made.

A second issue associated with the Kansas City Data Center is the proper level of annualized expenses. Although Staff does not admit that its calculation contains errors, there is no follow-up to Staff witness Rucker's statement that she would review the matter. On this basis, the Commission believes that SWB's calculation of the expense level is the only one supported by the evidence and is therefore adopted.

Income Taxes

A. Vacation Pay

This issue revolves around a book/tax timing difference related to the difference in the treatment on SWB's books of vacation pay owed SWB employees and the treatment in SWB's income tax calculation. Vacation pay is deducted in the year it is paid for tax purposes, but for book purposes, under Part 32, it is accrued in the year it is earned. SWB contends that it had flowed through the book/tax timing differences for vacation pay since the Commission's order in Case No. TR-79-213, until the Commission order in Case No. TC-89-14 required normalization of the timing differences.

For 1988 SWB deducted on its tax return the expense for vacation paid in 1988. Also in 1988, because of the implementation of Part 32, SWB accrued on its books vacations earned in 1988 to be paid in 1989. This transition from expensing vacations as paid to accruing them as earned caused a double booking for vacation pay in 1988. Part 32 authorized the booking of the expense for vacations paid in 1988 as an amortization over a ten-year period. SWB contends this ten-year amortization of the 1988 vacation paid reverses the flow-through of the tax deduction on the 1988 tax return. SWB contends further that the back expense of this amortization must be flowed through since the tax deduction has been flowed through.

SWB also proposes an adjustment to rate base to include the off-book vacation pay deferred tax reserve account. This off-book deferred tax reserve, SWB contends, reflects the flow-through of the tax benefits to Missouri ratepayers.

Staff opposes the tax treatment proposed by SWB and the rate base adjustment. Staff contends that the book/tax timing benefits were not ordered to be flowed through in TR-79-213. Staff then contends that the tax laws were changed in 1987, in the 1987 Revenue Act, to eliminate the book/tax timing difference. Staff argues further that Part 32 again created the book/tax timing difference and that the Commission ordered normalization in Case No. TC-89-14, and so there was no flow-through of 1988 vacation pay.

Staff then makes two additional points with regard to this issue. First, ratepayers have provided 110 percent of annual vacation pay through rates set in TC-89-14 and they have not received any tax deduction benefit for the additional 10 percent. Also, Staff witness Schallenberg points out that if flow-through had occurred, the booked levels of expense reflected in Exhibit 37, Schedule 7-2, should include an additional line item of approximately $27 million as a further income tax deduction.

The Commission finds that the evidence supports SWB's position concerning the treatment of vacation pay for expense and rate base. Even though Schallenberg suggests that an additional line item of approximately $27 million should appear on Exhibit 37, Schedule 7, the Commission is not convinced this is necessary. The evidence indicates that prior to tax normalization ordered in TC-89-14, tax timing differences to vacation pay were flowed through. The ten-year amortization has already begun. This was recognized in the sharing under the experimental incentive regulation plan. The Commission finds this expense should be added back and the related rate base treatment should be recognized.

B. Amortization of Investment Tax Credit Balance

SWB explains in its testimony that federal tax law provides incentives for companies to increase capital investment. The incentives were made available to SWB and other regulated companies through the use of normalization provisions. The differences between the timing of depreciation expense for tax return purposes and for ratemaking (book) purposes create book/tax timing differences. These differences create a deferred tax reserve. Deferred tax reserve is subtracted from rate base in the ratemaking process. The normalization provisions relate to the investment tax credit (ITC) taken by SWB and create a book/tax timing difference. The tax law provides that a ratable portion of ITC may be used to reduce a company's cost of service for ratemaking purposes. This ratable portion is called ITC amortization. SWB asserts that the tax law states that the period of time used for determining ITC amortization must be the same as the period of time used for computing depreciation expense.

Staff initially calculated the ITC amortization as of test year 1991 while computing depreciation as of September 1992. Staff recalculated its ITC amortization at September 1992 levels but did not change the balance in its case based upon what it considered the immateriality of the difference. Staff witness Meyer states that the remaining differences with SWB on this issue are SWB deductions made to the amortization of the ITC balance for allocation to deregulated services and for compensation study effects. Staff asserts that the deduction for deregulated services should not be made and that SWB has provided no records showing which, if any, of the deregulated property generated ITC. Staff opposes the deduction for the effects of the compensation study, asserting that the amount calculated by SWB is incorrect. Staff also asserts it did not have the data from which to make an accurate calculation.

The evidence on this issue and especially the cross-examination of Meyer demonstrates that when Staff brought its calculation forward to September 1992, it removed almost all of the ITC amortization associated with deregulated property and compensable property. The removal of these items brought Staff's updated calculation to approximately the same level as is reflected in its original case. Staff objects to ITC amortization associated with compensable property because it believes that SWB's calculation assumes all property associated with compensable property generates ITC.

Staff retained $50,000 of the ITC amortization associated with deregulated property and compensable property. The $50,000 was not based on any calculation but was a figure arrived at by consultation with other Staff members. Meyer on cross-examination admitted the $50,000 was not the right number for this item.

The Commission finds that the reduction by Staff in ITC amortization associated with deregulated property and compensable property is not supported by the evidence in this case. The only support for Staff's position is its belief that SWB's calculation is wrong and the belief that all compensable property did not generate ITC. Neither of these positions rise to the level of competent and substantial evidence. Staff's case is further eroded by the admission that some amount should be included for these items. The Staff's $50,000 has no support in the record. Even if Staff intuitively believes SWB's calculation flawed, it was based upon a ratio similar to that used for other calculations. This method is more reasonable than Staff's.

C. Excess Deferred Income Tax Amortization

An excess in deferred taxes arises when income tax rates for SWB are reduced. This occurred when the Tax Reform Act of 1986 (TRA) reduced the corporate federal income tax rate from 46 percent to 34 percent. The excess is then created since the taxes are deferred at 46 percent but only paid back at 34 percent. The excess will not be paid back and must be removed from the deferred tax reserve.

The differences between SWB and Staff on this issue are similar to those in the previous issue, ITC amortization. Here, as in that issue, Staff initially used the test year 1991 balance for excess deferred taxes. SWB argued that the balance should be updated to September 1992, to which Staff later agreed. Staff, though, made two adjustments to the updated balance. Staff does not reduce the balance for allocation to deregulated service and to recognize effects of the compensation study on the balance. Staff proposes no deductions related to deregulated services and argues that the figures associated with the compensation study cannot be verified. Staff argues that acceptance of SWB's calculations associated with the compensation study would mean that all compensa-able property was placed in service before the TRA. Staff reflected $50,000 in the balance for these two items.

The Commission finds that based upon the evidence in this case, SWB's proposed balance for excess deferred taxes is more reasonable. Staff admits that some recognition of deregulated service and the compensation study must be made in the balance. The Commission finds that Staff's $50,000 amount is purely arbitrary and based upon no evidentiary support. SWB's calculations may be flawed but there is some evidence to support the calculations. The lack of documentation may be a contributing factor to Staff's position but in this instance there is no support for making the adjustment Staff proposes to the excess deferred tax balance.

Staff objected to the revised testimony on this issue and the ITC amortization issue of SWB witness Toti found in Exhibit 37 at page 80A. A ruling on the objection was taken with the record. The Commission will overrule that objection. The two paragraphs merely restate SWB's position, which is set out elsewhere in its evidence.

D. Cost of Removal/Salvage for Pre-1981 Property

The cost of removal (COR) and gross salvage are accrued over the book life of the related property through the book depreciation process. COR is reflected on SWB tax returns in the year it is actually paid or incurred, which occurs when property is retired or removed from service. The tax law provision under which the related property is being depreciated prescribes when salvage is to be reflected on SWB's tax return. Pre-1981 property is depreciated under a different provision than property placed into service later.

Because COR and salvage are accounted for in different periods on SWB's books and income tax return, a book/tax timing difference is created. This creates a deferred tax balance associated with these items. Staff in its case did not propose a reduction of the deferred tax balance associated with COR and salvage. SWB proposes a reduction based upon its position that the flow-through of the tax benefit to ratepayers prior to 1981 should be recognized to prevent a double benefit being received by ratepayers.

The Commission finds that a reduction of the deferred tax balance for COR and salvage is not appropriate. Regardless of whether flow-through was ordered prior to 1981, the evidence indicates that for book purposes COR was greater than salvage when applied to the investment base at the end of the year. SWB does not depreciate its property above 100 percent, so no deferred tax could be generated. SWB argues that there is an off-book adjustment because the tax deduction has exceeded book expense. The Commission finds that Staff's position more properly reflects the COR and salvage level in SWB's deferred tax balance and the adjustment for off-book tax deductions is not appropriate.

E. Nonproperty-Related Deferred Taxes

SWB asserts that there are accumulated deferred income taxes related to income from nonproperty-related items which should be included in rate base for this case. Inclusion of these accumulated deferred income taxes is required, according to SWB, because of full income tax normalization under Part 32. SWB reiterates its argument that the Commission adopted Part 32 in Case No. TC-89-14 and therefore, as a requirement of Part 32, all nonproperty-related accumulated deferred income tax should be recognized in rate base. The evidence supporting SWB's position is found in Toti prefiled rebuttal testimony, Exhibit 37, pages 87-89. Toti testified that the nonproperty-related deferred taxes in this case are primarily created by the book tax treatment of RTU fees.

Staff did not include the accumulated deferred income taxes associated with nonproperty-related items in its initial rate base calculation. Although Staff opposes the inclusion of these deferred taxes in rate base, it appears from the record that no testimony or evidence was presented on this issue.

Staff witness Meyer does testify to the recomputation of the tax straight line depreciation rates to take into account RTU fees that are capitalized and then deducted for tax purposes. Meyer, though, does not address the accumulated deferred income taxes associated with RTU fees. In addition, Staff's brief is not clear on what Staff's position is. In its reply brief Staff finally opposes the inclusion of the accumulated deferred income taxes in rate base because they are associated with RTU fees at the September 1992 level, which was an abnormally high level.

The Commission finds that Staff's adjustment is not supported by any evidence and therefore is not appropriate. Even accepting that the accumulated deferred income taxes are associated with RTU fees, this fact does not convince the Commission that they should be excluded from rate base. Without some supporting evidence, the Commission cannot adopt Staff's position.

Interest During Construction

Interest during construction (IDC) has been included in the revenue calculation to provide a return on funds used during construction and not included in rate base. Staff and SWB differ concerning the rate of interest to be used in calculating IDC. Staff proposes the use of SWB's short term debt rate, while SWB proposes to use a weighted average cost of capital.

Staff's proposal is based primarily on two factors. First, Staff asserts that SWB supports its construction projects with depreciation expense, which Staff contends is cost-free and therefore no return is appropriate for these funds. Second, Staff asserts that SWB has not issued equity or used long term debt to fund construction and therefore these costs should not be part of the IDC calculation. In addition, Staff asserts that allowing IDC is requiring ratepayers to pay a return on a return and thus pay twice.

The Commission finds that IDC as calculated by SWB is appropriate. Depreciation expense is not cost-free. SWB may choose to use its accumulated depreciation expense for construction, but this is at a cost since it could choose to use these funds elsewhere. Depreciation is the return of shareholders' investment to them and SWB's use of that money again requires a return for that use.

The Commission also does not believe the fact that SWB's capital structure has been stable and that SWB has not issued equity for construction warrants Staff's result. In response to Staff's proposal, SWB could return all of its depreciation expense to its shareholders and then issue long term debt, and possibly shares of stock, to fund construction. This would not benefit ratepayers and is unnecessary. The Commission believes use of shareholder funds requires a return and the return should be the overall weighted cost of capital which shareholders would earn on rate base.

Short Term Telephone Plant Under Construction

Short term telephone plant under construction (TPUC) includes the costs of construction projects which are designed to be completed in twelve months or less. Once these projects are completed the balances associated with the plant are transferred to plant in service. For construction projects which are designed to be completed in more than twelve months, long term TPUC is accounted for on SWB's books.

Staff did not include short term TPUC in rate base in its calculations for this case. As stated in its initial brief, SWB proposes including short term TPUC in rate base for five reasons. First, the balance is relatively small in relation to SWB's total rate base. Second, Part 32 directs the inclusion of short term TPUC in rate base. Third, the projects being constructed during the test year are already transferred to plant in service. Fourth, the short term TPUC is associated with replacement facilities or central office upgrades which will not result in additional net revenues. Fifth, rate base includes other items which have similar characteristics to short term TPUC.

The Commission finds that short term TPUC should not be included in rate base. Even though the construction associated with short term TPUC balances as of September 30, 1992, will be in service at the time this Report And Order is issued, the balances are outside the test year as updated for this case and will involve providing funds for future plant. Historically, the Commission has not allowed costs associated with future plant unless very unique circumstances exist. No such circumstances exist with short term TPUC in this case. In addition, the inclusion of these balances would distort the rate base/revenue/expense matching which SWB finds so compelling in other issues.

There are potentially cost savings and revenues associated with the facilities under construction and without evidence to show that these offsets to short term TPUC costs are recognized, the test year levels would be distorted. In addition, the Commission is not convinced that SWB's assertion that projected revenues are offset by the additional depreciation expenses. These adjustments are speculative since any revenues and depreciation expense are not known and measurable.

Short term TPUC is not allowed in rate base and IDC is earned on these balances. The Commission has adopted SWB's position on IDC and so shareholders are compensated for the use of their capital investment. This method is preferable to the recognition of future plant in rate base. In addition, this method also preserves intergenerational equity.

The Commission finds, further, that the size of short term TPUC is not relevant to the question of whether it should be included in rate base. The Commission also finds that SWB's reliance on Part 32 in this instance is misplaced. In Case No. TC-89-14 the Commission generally adopted Part 32 for ratemaking purposes for SWB, but the Commission references specifically FAS 13, 43 and 87 in adopting Part 32 and the issue of expensing of executive salaries. 29 Mo. P.S.C. (N.S.) at 617. This decision focused on those specifics and does not preclude the Commission from reviewing Part 32 requirements in this case and deviating from those requirements where they are found to be inappropriate. This issue is an instance where Part 32 does not provide what the Commission considers to be the proper ratemaking treatment.

Cash Working Capital

Cash working capital (CWC) is the amount of cash necessary for a utility to pay the day-to-day expenses incurred in providing service to the ratepayer. A lead-lag study is used to determine the amount of cash a utility must provide in order to maintain service. The use of a lead-lag study has been approved by the Commission in numerous rate cases as an accurate and competent method for calculation of the cash working capital requirement.

When the utility must pay for an expense incurred to provide service before the ratepayer has paid for the service, cash must be provided to do so by the shareholder. The shareholder is then entitled to a return on that advance, generally as a part of the rate base. If the ratepayers have provided the capital to the utility before the utility has had to pay for the expenses of providing service, the negative cash working capital balance should be removed from rate base, as the shareholder is not entitled to a return through rates on that amount.

To determine the CWC requirement, a revenue lag is computed which denotes the amount of time, expressed in days, between the midpoint of the period during which the utility provides service and the payment for that service by the ratepayer. According to Staff, a collection lag is one of several subcomponent lags which comprise the revenue lag, and is defined as the period of time between the day the bill is placed in the mail by the utility and the day the utility receives payment from the ratepayer for services rendered. The only aspect of the CWC calculation presented for the Commission's decision is the issue of the proper computation of the collection lag, as all other issues related to its calculation have been resolved. [illegible] proposes a collection lag of 28.46 days, while Staff recommends a collection lag of 21 days instead.

A total of four studies were undertaken by SWB and Staff to determine the collection lag:

(1) SWB performed an accounts receivable turnover ratio computation to calculate the collection lag, and determined that its collection lag is 28.46 days. The computation divides the total daily accounts receivable balance by the total daily cash collections for a specified period of time, in this case for the months from April through June of 1991.

(2) SWB also used a different method to compute the collection lag by sampling all customer bills rendered for June of 1992 service and capturing the subsequent payments for these bills. This method produced a collection lag of 32.67 days.

(3) Staff performed a modified accounts receivable turnover study for the period from October of 1991 through October of 1992 and found a collection lag of 25.84 days. In performing this study, Staff began reducing the accounts receivable balance by the daily amounts of cash received from customers after 21 days.

(4) Staff also undertook a second study, which used a random sample of 200 customers and examined the payment history of each customer for the period from August 1992 to January 1993. This sample resulted in a collection lag of 29.52 days.

SWB asserts that there is no factual basis to dispute its calculation of a 28.46-day collection lag and that all other studies, including the ones undertaken by Staff, produced similar results. Staff's rejection of SWB's collection lag, SWB contends, is based solely on Staff's mistaken premise that the Commission's rule in 4 CSR 240-33.040 sets a maximum due date of 21 days within which customers must pay their telephone utility bills. According to SWB, Staff conceded that SWB customers pay their bills within 28 days, but claims the

28-day payment habit is unreasonable because it is different from other utility results. Yet Staff made no attempt to analyze SWB's collection policies or those of the other utilities, and the utilities used by Staff were not comparable to SWB. In response to a data request, Staff stated that the best practical way to determine a company's collection lag is to randomly select a certain number of customers and examine their payment habits, yet when Staff did this it came up with a collection lag of 29.52 days. SWB presented evidence that its uncollectible rates are low and support SWB's practices, and Staff's recommendation to automatically threaten disconnection after 21 days is not cost-effective. SWB also points out, in response to Staff's suggestion that SWB's results may have been skewed by the extra mailing time required for payments to reach Texas, that the 28.46-day figure was calculated before the consolidation of customer payment remittance operations in Texas.

According to Staff, on balance SWB's ratepayers provide cash working capital. Staff claims it is not sure whether SWB's 28.46-day collection lag has been calculated accurately, but it is sure the lag is excessive. Because Staff considers 28.46 days to be unreasonable, it has suggested 21 days as a reasonable proxy instead. The 28.46-day figure is unreasonable because SWB considers bills delinquent after 21 days and 10 days, respectively, for residential and business customers. Given this, the estimate of 21 days is therefore conservative, since it cannot be assumed that all customers will fail to pay their bills on time. In contrast, the use of a 28.46-day lag would lead the Commission to believe that all two million of SWB's customers pay their bills late. Staff also suggests that a moderate late payment charge might help improve the collection lag, or at least help defray the costs associated with this issue.

Upon cross-examination, Staff's witness admitted that he had found no flaw in SWB's measurement of its collection lag, although he insisted that it was possible a flaw existed. The witness further testified that the best way to measure the collection lag is through studies such as the ones which were performed in this case, but that he had determined that the results of the four studies were unreasonably high, based on the Commission's rule in 4 CSR 240-33.040 and on Exhibit 187, Schedules 1 and 2, which contain comparative collection lags for other telephone utilities and other nontelephone utilities, respectively. In addition, the witness stated that SWB's credit and collection practices played no part in his opinion.

The underlying bases for Staff's support of a 21-day collection lag are not well-founded. Commission rule 4 CSR 240-33.040(3) provides in pertinent part: "If a telephone utility does not expressly offer a preferred payment date plan, a customer shall have at least twenty-one (21) days from the rendition of a bill to pay the charges stated...." The rule then goes on to expound on exceptions to this general rule. The rule itself is directed at utility behavior and not directly at customer behavior, and merely provides for a minimum amount of time a utility must give its customers to pay from the rendition of a bill before the utility may consider the bill past due and take further action. In addition, Staff's witness admitted on cross-examination that the comparative collection lags for other utilities found in Schedules 1 and 2 were Staff's suggested lags, and did not know whether any of the lags had been authorized or approved by the Commission.

The Commission determines that Staff's evidence is insufficient to justify the use of its proposed 21-day collection lag and finds, based upon the evidence presented, that it is more appropriate to use SWB's collection lag of 28.46 days. The Commission thus approves the use of SWB's collection lag for the calculation of the appropriate amount of cash working capital.

Depreciation

Depreciation expense is a major component of any regulated company's revenue requirement. The expense is the return of shareholders' investment in plant. Depreciation expense is calculated by establishing depreciation rates for a company's plant accounts. These rates reflect the rate of expected retirement of the facilities in each account.

This Commission has adopted the straight-line equal life groups and straight-line remaining life techniques for calculating depreciation for regulated telecommunications companies. These methods are designed to recover total costs of plant recorded in each account even if the estimated life of the plant changes over time. Calculations of the two methods rely on historical records, future net salvage value, and some judgment based upon nonhistorical factors.

Because SWB is regulated by both the Federal Communications Commission and state commissions, including this Commission, meetings are held every three years to try to reach agreement on the parameters of each plant account. These parameters are then used by the various regulatory bodies to establish depreciation rates, and thereby depreciation expense, for SWB within their jurisdictions. These meetings, referred to as three-way meetings, develop parameters for projected lives, curve shapes, future net salvage and remaining lives. Even if agreement is reached on parameters, different depreciation rates may result because of different depreciation reserve amortizations. The last three-way meeting was in 1992, so the next will be in 1995.

As a result of the three-way meeting in 1992 agreement was reached for parameters in 32 of SWB's 34 accounts. SWB and the FCC staff agreed on all parameters for all 34 accounts. Missouri Commission Staff did not agree to the parameters for Accounts 2212 and 2232, Digital Switching and Digital Circuit-Other, respectively. In this case SWB proposes adopting the parameters of the agreement between it and the FCC staff and to bring Missouri depreciation rates into parity with interstate rates by amortizing the reserve difference for all 34 accounts.

A. Digital Switching

Staff proposes to continue the use of a 20-year projected life with the characteristics of the Iowa R1.5 curve for this account. SWB is proposing a 17.5 year projected life and a GM2.5 curve. There seems to be agreement that the difference in the curves of the two parties is minor so that the controversy focuses on the appropriate projected life for this account. Based upon Staff's projected life, depreciation rates for the Digital Switching account will decrease from the current 6.7 percent rate to a 5.5 percent rate while SWB's projected life will result in a depreciation rate of 6.6 percent.

The evidence indicates that Staff's parameters are those adopted in 1986 while SWB's are based upon an FCC staff analysis using what has been termed the "life-span method". The Commission finds that it cannot completely adopt either position but that the 17.5 year proposed life is more reflective of the future retirement on this account. The Commission supports the continued use of the straight-line equal life group and straight-line remaining life methods for determining depreciation accounting. The Commission, though, believes that significant changes have occurred in the industry since 1986 which should be reflected in the analysis of depreciation rates. These factors, if not reflected in historical data, should be factored in as nonhistorical considerations.

These changes include the continuing modernization of SWB's network, which results in early retirements of facilities. The date of future retirements based upon replacement of outdated facilities is an important factor in developing depreciation rates. Depreciation rates should reflect the early retirement of facilities based upon Commission decisions and the modernization agreement in the experimental incentive regulation plan. The issue is not SWB's reason for modernization but the fact that it has modernized. Also, the Commission believes that new technology is shortening projected lives and even though a specific replacement for digital switches is not readily apparent, it will come. The Commission believes it will come sooner than Staff contemplates.

As stated above, the Commission finds Staff's analytical methods are preferable. SWB's adoption of FCC staff's modified life-span method is not appropriate. The Commission agrees with Staff witness Richey that the assumption that no part of the property will last beyond 20 years is not correct. Even with the modularity effect as described by SWB witness Barfield, it is reasonable to believe that part of the digital switching equipment will survive beyond the 20 years.

Even though SWB's method is flawed, the Commission finds that the shorter 17.5 projected life recommended by SWB is more reasonable. Maintaining the 1986 projected life for digital switching equipment does not reflect the changing conditions of the telecommunications industry. Perhaps more recent analysis using Staff's method would reflect a projected life greater than 17.5. There is no evidence, though, from which to find a projected life between 17.5 and 20 years and, as stated above, the Commission finds the continued use of the 20-year projected life is not reasonable.

D. <u>Digital Circuit-Other</u>

This issue presents the Commission with a different aspect of calculation of depreciation rates. Although it can be suggested the philosophical argument is the same as that in the Digital Switching issue, the facts are different. Staff has proposed retaining the 15-year projected life for this account agreed to in 1989. SWB proposes a 12.5 projected life. The difference in the two positions focuses mainly on the treatment of the split of the circuit accounts in 1988. The digital portion of the account was separated from the analog portion, thus creating the Digital Circuit-Other account at issue here.

Staff maintains that the two years of data available for the Digital Circuit-Other account provides insufficient information to arrive at a new projected life and so Staff has retained the 15-year projected life from the combined account. SWB used a life cycle technique to forecast future remaining life for technology groupings within the account. SWB combined the two-year data of the account with this forecasted data to arrive at its projected life.

The Commission finds that the use of the current 15-year projected life is reasonable until more data is available for this new account. Forecasts concerning future expectations should be a part of any depreciation analysis but there must also be a sufficient data base of historical data upon which to base an analysis. Forecasts, as Staff asserts, can be very sophisticated or intuitive. When balanced with sufficient historical data, well-documented forecasts should provide reliable results on projected lives for this account. Without sufficient historical data, the Commission finds that the current projected life should be maintained.

C. Annualization to Achieve Parity

This issue requires little discussion since there is no parity now among the five states in which SWB operates nor between those states and the FCC. Different depreciation parameters may be the result of different analyses or different weighing of evidence in each jurisdiction. There appears no reason to bring FCC and Missouri rates to parity in this case, especially since the Commission has not adopted the parameters agreed to between the FCC and SWB.

In addition, the Commission does not believe it is sound regulatory policy to place itself in lockstep with the FCC, which has different priorities and different concerns with regard to SWB and the telecommunications industry.

There may always be times when state policies or concerns are different from federal policies and concerns. Any precedent that might limit this Commission or future Commissions in addressing issues differently than the FCC should be avoided.

Compensable Property

SWB has property in each of the five state jurisdictions in which it operates which provides a benefit or service to one or more of the other states. To determine the appropriate amount of investment in a state, such as Missouri, which provides a benefit or service to another state, SWB performs an annual Compensable Property Study. Based upon the results of the study, each state compensates the other states for the expenses and investment associated with compensable property.

For this case both Staff and SWB have agreed that the 1993 study period, which is based upon actual data through June 30, 1992, is appropriate. SWB and Staff differ in their calculations of the depreciation reserves and deferred taxes applicable to Missouri. SWB has used state-wide average reserve percentages in its calculations while Staff has developed a new method based upon assigning reserves by primary account, and also proposes separate treatment of three large compensable assets.

Based upon the 1993 study, Missouri charged $908 million of investment to other states. This amount is eliminated from SWB's Missouri rate base. It appears that the Compensable Property Study involves a time-consuming and complex operation. Because of the magnitude of the study, SWB uses averages to arrive at some of the components in its calculations. SWB proposes to use these same averages in determining the amount of depreciation reserves associated with compensable property.

Staff has developed account-specific information to calculate reserves. Staff contends that the use of account-specific information is necessary to accurately define the Missouri cost of service. In addition to using account-specific reserves, Staff separates out three large compensable assets for separate treatment. These assets are the St. Louis Data Center, One Bell Center (OBC), and computers. Staff contends the use of state-wide averages has been rendered unsuitable for determining reserves for compensable property because of the substantial new investment in these assets. Staff points out that the data center and OBC constitute 51.8 percent of compensable property while compensable property is a much smaller percentage of total Missouri rate base upon which the state-wide averages are based.

The Commission has reviewed this issue and finds that SWB's state-wide averages are more appropriate based upon the evidence in this case. The evidence indicates that Staff's new method was not clearly thought through before it was presented. Numerous calculation errors, admitted to by Staff, and the failure to recognize originally that OBC and computers should be treated in a manner similar to the data center, detract from Staff's overall contention that its method more accurately reflects the proper depreciation reserves for compensable property. Although the Commission may agree with Staff that the use of the average depreciation reserve percentages overstates the depreciation reserve on assets that are less depreciated than the average and it understates the depreciation reserve on assets that are more depreciated than the average, the Commission is not convinced Staff's calculations using its new method are appropriate.

It appears that Staff has made a complicated process even more complicated in an attempt to address the new buildings and computers. This singling out of the data center, OBC and computers may appear to benefit Missouri ratepayers in this case, but the Commission is not convinced that this benefit will continue over time. The Commission finds that the averages used in the Compensable Property Study, although less specific, will, over time, more properly reflect SWB's ongoing operations. Even though the data center has only been in operation a short time and therefore has little depreciation reserve, this will not be true on an ongoing basis. This is even more true for OBC and computers since they have been depreciating over a longer period than the data center.

Staff faults SWB for not keeping records which identify the depreciation reserve and deferred taxes related to compensable property. The Commission is not convinced this specificity is required. If more specificity is required, Staff should request the Commission to order SWB to keep the necessary records. Staff's evidence concerning its more specific method of calculating depreciation reserve associated with compensable property has not convinced the Commission that it should require changes from the averages used by SWB. Averages do provide some simplification and efficiency in this process and the added complexity associated with Staff's position may not be productive.

St. Louis Data Center

Staff in its case recognized in rate base the St. Louis Data Center. Staff, though, has not provided for the expenses associated with the data center in its revenue requirement calculations. Staff included in its case the operation and maintenance (O&M) expense for 14 South Fourth Street and other costs associated with office space vacated by employees who moved to the new data center. Staff maintains that no additional recognition of O&M expense is appropriate since total Missouri maintenance expenses related to compensable property decreased over $3 million from 1991 to 1992. Staff asserts that increasing O&M expenses for the data center, therefore, is not logical and the adjustment does not recognize corresponding expense decreases for buildings from which employees moved.

The Commission recognizes Staff's point that compensable property expenses have decreased and, therefore, how can O&M expenses be increased for the St. Louis Data Center? The Commission, though finds that the determinative point on this issue is that Staff did not recognize any expenses associated with the new data center in its revenue requirement calculation. The Commission finds that utilizing the O&M expenses associated with 14 South Fourth Street is not appropriate. The O&M expenses for the data center are known and measurable and if they were not reasonable, an adjustment should have been made to that expense item. The evidence that Staff failed to even recognize the expenses leaves the Commission with only one alternative and that is to include the expenses as calculated by SWB.

Affiliate Transactions

SWB sells services and products, and buys services and products, from nonregulated subsidiaries of SBC. These transactions are referred to as affiliate transactions and are of particular concern and sensitivity because of the potential for abuse by SWB and its affiliates and the need to review information concerning nonregulated companies in determining whether those abuses have occurred.

The FCC has reviewed the problems associated with affiliate transactions between a regulated subsidiary and a nonregulated subsidiary of a parent company and has established rules and regulations concerning those transactions.

SWB generally describes the FCC requirements for services and products sold by a regulated company to a nonregulated affiliate as follows:

(1) use of a tariff rate where one exists;

(2) where a tariff rate does not exist, use prevailing market price (the price the service is sold to nonaffiliate companies);

(3) for a product, record the higher of fair market value or net book value if no prevailing market price has been established;

(4) for services where no prevailing market price has been established, record no lower than the fully distributed cost (FDC) developed by SWB.

Where SWB is purchasing products or services from an affiliate, FCC rules require:

(1) charges recorded on SWB books must be no higher than prevailing market price based upon rates to nonaffiliated customers;

(2) for a product, if no prevailing market price has been established, record the lower of net book value or fair market value;

(3) for services, if no prevailing market price is established, record no greater than the affiliate's FDC for the service.

SWB explains that FDC calculations required by the FCC are:

(1) directly assign costs whenever possible;

(2) costs remaining should be allocated based on direct measure of use where possible;

(3) costs remaining after (1) and (2) should be allocated based on indirect measures of use where possible;

(4) general costs remaining after (1), (2) and (3) should be allocated using a general allocator based on total expenses previously assigned and/or allocated.

SWB professes that it complies with the FCC requirements for affiliate transactions and FDC studies. Staff, in an attempt to verify SWB's position, hired a consultant to review SWB's affiliate transactions for this case. The consultant, Technical Associates, Inc. (TAI), conducted substantial discovery and prepared a report concerning SWB affiliate transactions which is contained in multiple volumes. TAI's report in general finds that SWB does not provide the necessary audit trail for reviewing SWB affiliate transactions, fails to adequately determine prevailing market price for services sold to affiliates, omits and understates expenses in the calculation of FDC for services sold by SWB to affiliates, uses revenue as a cost allocator instead of expense as required by FCC rules, lacks fully developed costs for some services sold to affiliates, and has a bias in favor of affiliates caused by the difference in FDC studies performed by SWB and its affiliates. Based upon these findings, Staff has recommended a $2.72 million adjustment which reflects estimated revenue shortfalls because of these shortcomings.

TAI also proposes the Commission require SWB to revise its policies and procedures to include:

(1) the establishment of a centralized group of employees within SWB, provided with sufficient resources, who oversee and are held accountable for all aspects of affiliate transactions;

(2) the preparation of a procedures manual, ultimately distributed to all appropriate personnel, which specifically sets forth criteria by which the reasonableness of SWB's affiliate transactions is to be tested, as well as all events (and their purpose) in the affiliate transactions process;

(3) the adoption of standardized analytical procedures for determining, on a recurring basis, prevailing market prices and other competitive tests of affiliate transactions using competitive bidding, independent price determinations, and market studies;

(4) the creation of an indexed set of documents, specifically referenced in the procedures manual in (2), which will truly serve as a "road map" or "audit trail" through SWB's affiliate transactions;

(5) the implementation of fully distributed costing methodologies which properly take into account all relevant costs; and

(6) the adoption of audit procedures by which SWB would test, on a recurring basis, that it is paying the lowest possible prices for purchases from affiliates with reference to competitive market standards as well as its own fully distributed costs and those of its affiliates.

The issue of whether SWB is charging appropriate prices for services and products bought from affiliates and whether it was being paid appropriate prices for services and products sold to affiliates was addressed in the Report And Order in TC-89-14. 29 Mo. P.S.C. (N.S.) at 655. In that case the Commission did not adopt Staff's proposed ROE adjustment but did find that SWB's failure to use market information and to document its pricing criteria raised concerns about SWB's affiliate transactions. The Commission indicated that Staff should review SWB's pricing policies in future cases.

Staff has performed the review suggested by the Commission for this case. That review, though, has generated such a volume of evidence that the issue has become a case within a case. Based upon its review of the evidence, the Commission, again, cannot adopt Staff's proposed adjustment. The calculation of the adjustment is based upon TAI's recalculation of SWB FDC studies and use of prevailing market price where data was available and the price was greater than FDC. This recalculation was performed even though TAI admittedly could not verify SWB's FDC results because of a lack of data concerning the underlying costs. TAI's use of its own recomputed FDCs, which comprise the largest part of its proposed adjustment, is too speculative and arbitrary for the Commission to adopt as an adjustment in this case.

The Commission finds that two related factors also have convinced the Commission that there is little support for TAI's proposed adjustment. First, TAI took a blunderbuss approach to its review of SWB's affiliate transactions. This approach left TAI with an unmanageable amount of information for which it could find no discernable method of absorbing. This required TAI to reduce its focus to a specific number of areas, but even this appears not to have helped clarify its analysis. The failure to find clarity, though, is also a function of SWB's failure to be completely forthcoming in its discovery responses. For example, SWB provided witnesses at the hearing as its experts on the affiliate transaction process which TAI indicates it never heard from during discovery. If SWB experts had dealt with TAI during discovery, perhaps TAI's analysis would have been better focused.

Finding that TAI's approach and SWB's responses were not conducive to a clear record, though, does not resolve this matter. Serious concerns have been raised by TAI regardless of its approach. The Commission agrees with TAI that the Commission should be able to review SWB's compliance with FCC regulations and be able to clearly track SWB's affiliate transactions. This, it appears, the Commission cannot do.

Questions raised by TAI need to be addressed and resolved. Some of the matters that need to be addressed are:

(1) is there a loophole in the FCC acceptance of FDC studies instead of determining prevailing market price for services only bought and sold by affiliates?

(2) use of revenues by SWB to develop its general expense factor.

(3) failure to assign administrative costs to some affiliate transactions.

(4) the use of different costing procedures for affiliate transactions and those used for allocations between regulated and nonregulated operations.

(5) failure to provide the underlying data for FDC and market price studies.

(6) would the price of market studies outweigh the benefit from the results of these studies?

The above matters are not intended to be exhaustive but only illustrative of the unresolved issues concerning affiliate transactions. This area of SWB's operations appears to be so complex, or at least voluminous, that the Commission finds it is irreconcilable under current procedures in a general rate case or complaint case. Too many underlying issues concerning data, market studies, proper FDC to use, and other questions, must be resolved prior to any determination of whether SWB is complying with FCC directions or whether those directions are sufficient and whether an adjustment is appropriate.

Rather than leave these matters to the vagaries of the next case, the Commission has determined that a review of SWB's affiliate transactions should be conducted in a separate docket. The docket would not be to determine a monetary adjustment but would be created to decide whether SWB's procedures are adequate and to establish a method of reviewing SWB's affiliate transactions within a rate case format to see if SWB is following the approved procedures. The Commission could not perform this necessary function in this case.

Southwestern Bell Corporation

SWB is one of several operating subsidiaries of Southwestern Bell Corporation (SBC). The other operating subsidiaries include: Southwestern Bell International Holdings Incorporated; Southwestern Bell Mobile Systems, Inc.; Southwestern Bell Yellow Pages; Southwestern Bell Telecommunications, Inc.; Metromedia Paging Systems, Inc.; and Southwestern Bell Printing Company. SBC as the parent company provides services for its subsidiaries such as legal, treasury, comptroller, shareowner services, financial reporting, strategic planning and human resources. SBC also has administrative subsidiaries which exist for support of operating subsidiaries or SBC. These companies provide such services as transportation, technology research, legislative and regulatory advocacy benefits, administration and other administrative services.

Since SWB is regulated by the FCC and state commissions, costs allocated to it by SBC are closely scrutinized and are subject to specific regulatory requirements. The FCC regulations which control the allocation procedure are the same as those discussed in the Affiliate Transactions issue. These FCC cost allocation rules apply specifically to the allocation of parent company costs to a regulated subsidiary. These rules were established by the FCC in its Report And Order, CC Docket No. 86-111, released February 6, 1987. The stated purpose of these rules is to eliminate the potential for any cross-subsidization between regulated and nonregulated activities.

The regulations require:

> (b) In assigning or allocating costs to regulated and nonregulated activities, carriers shall follow the principles described herein.
>
> > (1) Tariffed services provided to a nonregulated activity will be charged to the nonregulated activity at the tariffed rates and credited to the regulated revenue account for that service.
> >
> > (2) Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.
> >
> > (3) Costs which cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy:
> >
> > > (i) Whenever possible, common cost categories are to be allocated based upon direct analysis of the origin of the costs themselves.

(ii) When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another cost category (or group of cost categories) for which a direct assignment or allocation is available.

(iii) When neither direct nor indirect measures of cost causation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.

Staff's position on this issue is based upon its conclusions that SBC has not followed the above requirements in allocating costs to SWB. Staff believes that SBC is directly assigning or allocating to SWB unnecessary and duplicative costs and costs associated with functions SWB would not perform on a stand-alone basis. A brief description of Staff's proposed adjustments is found at Exhibit 35, page 13. These are:

(1) The Staff annualized the SBC allocated costs to SWB by updating the SBC factors to include only December, 1991 results.

(2) The Staff adjusted the SBC Investment Factor by including only the amount of funds provided by the shareowners (Common Stock and Paid-in-Capital) and adjusted for the capitalization of SBC's investment in Southwestern Bell International Holdings Incorporated (International).

(3) The Staff adjusted the allocation process by requiring SBC to share a portion of the allocable common costs by including its retained expenses in the calculation of the general factor. SBC will also be considered a business unit and share in the costs for Adjustment (4) below.

(4) The Staff reclassified a portion of SBC's allocated costs based on investment and employees to a business unit allocation.

(5) Based on the adjustments made to (3) and (4) above, the Staff recalculated the allocation of SBC's costs based on the general factor.

SWB made four categories out of Staff's proposed adjustments and Staff seems to have adopted these categories in Staff witness Schallenberg's surrebuttal testimony, Exhibit 218, page 8. In addition, the Reconciliation, Exhibit 244, contains dollar amounts related to the four categories under the general heading "SBC". The Commission will discuss this issue using the four categories. This will allow for a direct link between the issue and the proposed dollar adjustments and will focus the discussion on the most relevant evidence. As with Affiliate Transactions, there is a significant amount of underlying information that has been placed into evidence. The Commission has attempted to narrow its focus to that evidence it finds persuasive.

A. <u>Business Unit Adjustment</u>

Staff does not believe that the use by SBC of investment and employee allocation factors to assign costs meets the FCC requirement that, whenever possible, common cost categories are to be allocated based upon direct analysis of the origin of the costs themselves. Instead of SBC's allocation using the investment and employee factors, Staff developed a business unit approach for allocating costs. To assign costs under its business unit approach, Staff grouped SBC, SWB and the other subsidiaries into four units. Staff then allocated common costs equally to each unit.

Although Staff has pointed out several instances where the investment and employee factors may not allocate costs appropriately, the Commission finds that those allocations are more reasonable than Staff's business unit approach. There appears to be no precedent for use of a business unit approach such as Staff has utilized for allocating costs. Even Staff could not provide evidence of its general acceptance. In addition, the groupings appear to be arbitrary and do not reflect the dominance of SWB in SBC's corporate structure. As with the Rate of Return issue, there is no disputing that SWB dominates SBC's activities. SWB has 86 percent of SBC's employees and 77 percent of SBC's investment. Staff's approach would largely ignore this fact. The investment and employee factors are generally accepted allocators for common costs and the evidence supports their use.

B. SBC General Factor Adjustment and Inclusion of SBC in General Factor

Although four categories are set out in the Reconciliation on this issue and by SWB witness Wepfer, both Staff and SWB have addressed the SBC general factor adjustment issue and the inclusion of SBC in general factor together. In addition, Staff witness Schallenberg states in his supplemental surrebuttal testimony, Exhibit 218, page 23, that he is not sure what the SBC general factor adjustment issue is, even though he earlier states that he adopts the four categories.

From the briefs it appears that the SBC general factor adjustment flows from the business unit adjustment. If that is the case, the use of SBC as a business unit suffers from the same flaw as does Staff's use of the business unit method to allocate common costs. If that is not the case, there is no evidence from which to make an adjustment, so none will be made.

The issue of whether to include SBC in the calculation of the general allocation factor is more straightforward. The evidence indicates that SBC retains certain costs rather than assign them or allocate them to subsidiaries. Staff contends that FCC rules require the general allocation factor be "computed by using the rates of all expenses directly assigned or attributed to regulated and nonregulated activities." Staff's position is that SBC by retaining costs is, in effect, directly assigning these costs and therefore those costs should be used in computing the general allocator.

SWB argues that retained expenses are neither directly assigned nor attributed and the allocation process is designed to allocate parent company costs actually allocated or assigned. In addition, SWB argues that SBC exists as a direct result of operating subsidiaries and performs functions solely on behalf of and for the benefit of its operating subsidiaries.

The Commission finds that the inclusion of SBC retained costs in computation of the general allocation factor is appropriate. The labeling of these costs as retained does not belie the fact that SBC has directly assigned these costs to itself since they provide no benefit to the operating subsidiaries. The retention of these costs also belies the fact that SBC exists solely for its operating subsidiaries. Other evidence also indicates that SBC does more than just exist for its operating subsidiaries. First, its creation was to provide management activities for its existing and future operating subsidiaries. The inclusion of future subsidiaries in its purpose reflects that a portion of its activities is unrelated to its existing subsidiaries but is focused on acquiring additional subsidiaries. These activities do not support or benefit existing subsidiaries, including SWB.

The Commission finds also that even though the FCC rules do not state that parent company costs are to be included in computation of the general allocator, there is no prohibition. The FCC rule does require that the general allocator be based upon expenses of both regulated and nonregulated activities. SBC's retained expenses fall within this requirement.

C. SBC Expense Disallowances

In addition to the general adjustments proposed by Staff to costs allocated by SBC to SWB, Staff also proposed some specific cost center adjustments. These adjustments include (1) executives (cost center 03600) and boards of directors (cost center 03700), (2) information cost center, (3) public information cost center, (4) trademarks, patents and graphic service, (5) tax group, and (6) cash management. In addition, there were several other specific disallowances proposed by Staff.

1. Executives and Boards of Directors

Staff claims that expenses related to the executives of SBC and the boards of directors for SBC are duplicative of SWB executives and board and unnecessary except for two outside directors and the allocated share of the SBC audit committee. Staff asserts that the need for two executives and boards of directors was caused by the increasing perception that SBC and SWB had separate needs. Since separate needs caused the separate executives and boards, Staff believes that SWB ratepayers should not be charged for SBC costs related to the activities unrelated to SWB.

SWB claims the executives and boards perform separate functions, with the SBC executive and board setting strategy and policy for the entire corporation while the SWB executive and board implement these corporate policies and manage SWB's day-to-day operations. SWB argues that the SBC executive and board work on a variety of matters common to the subsidiaries and these responsibilities are so broad that their costs are properly allocated to SWB using the general allocator.

The evidence indicates that 100 percent of the costs related to SBC's chief executive and board of directors is allocated using the general allocator, and that between 70-75 percent of these costs are allocated to SWB. This means that SWB ratepayers are paying almost three-fourths of the costs of these cost centers while much of the activity related to these costs involves mergers and acquisitions. This fact alone is enough to find that the general allocator is not appropriate for allocating these costs. SBC should separate out costs associated with mergers and acquisitions and retain or directly assign these costs to itself.

In addition to the merger and acquisition activities, Staff witness Schallenberg's surrebuttal testimony, Exhibit 318 and Exhibit 318HC, gives additional examples of how SWB executive and board activities duplicate SBC executive and board activities. The separation of these activities may be difficult, but SWB and SBC need to develop a process for ensuring duplicative and unnecessary costs are not allocated to SWB and that non-SWB related costs are assigned to those for whom the activity is performed. As a result, the expenses for these cost centers should not be allocated to SWB.

2. Information Cost Center

Staff asserts that the costs of SBC's employee information function are duplicative of SWB's employee information function. SWB claims that SBC's employee information activities relate to all SBC subsidiaries by providing SBC financial results, competitive issues, subsidiary products and services, and human resource issues. SWB then claims its employee information activities are directed specifically to telephone company concerns and activities.

The Commission finds that the duplication inherent in the dissemination by the two corporations is not sufficient to warrant a disallowance of the costs as proposed by Staff. It is good management policy to keep employees informed concerning both the parent company activities as well as those of SWB. Even though Staff states it has allowed all costs associated with telephone company issues and concerns, the Commission finds that information about the parent corporation is beneficial to SWB employees and the costs of disseminating this information is appropriate to include in SWB's cost of service.

3. Public Information Cost Center

Staff contends that the activities of the SBC publications cost center should not be allocated to SWB using the employee factor. The result of this allocation is that over [illegible] percent of the costs of SBC newsletters and publications is assigned to SWB.

The Commission finds that the employee factor is a reasonable method of allocating costs associated with newsletters and publications. These SBC activities are provided to all subsidiary employees, of which SWB is the largest component. There is also evidence that the activities of SWB and SBC news and public information groups are coordinated in an attempt to avoid duplication.

4. Trademarks

Staff proposes to disallow the costs from the trademarks, patents and graphics service cost center because SWB provides the value of the SBC name and other affiliates are able to benefit from this name recognition without any cost. Staff proposes that either the other affiliates pay a royalty for use of the name or they bear the costs of the cost center.

The evidence established that SBC owns the Southwestern Bell name and logo and that the costs associated with this cost center relate to the development and maintenance of corporate graphics and identity guidelines, and actions concerning use of the name and logo. The evidence indicates SWB does not perform any of these functions so they are not duplicative. The Commission finds, further, that there appears no basis for charging the other subsidiaries a royalty fee for use of the name and logo.

5. Tax Group

Staff proposes to disallow the cost allocated to SWB for the SBC tax group. Staff asserts the activities of this group are duplicative of SWB activities. The Commission finds that the SBC tax group performs more intensive tax research, long range corporate tax planning, monitoring current and proposed tax legislation and determining the potential effect on SBC and its subsidiaries. These activities are reasonable and necessary for the corporation as well as for SWB, and are appropriately allocated to SWB using the general allocation factor.

6. Cash Management

This cost center supports the costs associated with the administration of the corporation's cash management system, including management of SBC's short term debt portfolio, management of cash earmarked for dividend distribution, assessment of earnings and the effect associated with alternative investment options, the management of commercial banking relationships, preparation of SBC cash flow forecasts, bank account maintenance, and statement reconciliation and cash book operations.

Staff asserts that SWB maintains its own cash management function and activities and does not need this SWB service. In addition, Staff asserts the line of credit is worth only $70,000 to SWB.

The Commission finds that allocation of the SBC cash management cost center to SWB represents a duplication of costs for functions SWB performs for itself, or are unnecessary costs. SWB has its own cash management functions and for 1990 through 1992 SWB has received no cash advances from SBC. This cost center also includes the line of credit provided by SBC. SWB, though, maintains its own lines of credit. Finally, one stated purpose of the cash management cost center is to invest SWB's surplus cash. The evidence is that SWB rarely is in a surplus cash situation.

7. Other Expense Disallowances

Staff proposed disallowances for other SBC cost centers. These were not briefed and so appear to have been dropped. No adjustment will be made for these proposed disallowances.

Yellow Pages

Yellow pages directories contain listings of business telephone numbers and separate advertisements classified by general categories and lines of business. The publication of yellow pages directories, before the divestiture of AT&T, was a function of SWB operations. All costs and revenues were included in the determination of SWB's revenue requirement. Upon divestiture and at the behest of state public service commissions, the court left yellow pages directory operations with the Regional Bell Operating Companies (RBOCs), finding specifically that retention of this function by the RBOCs was in the public interest. *United States American Tel. and Tel. Co.*, 552 F. Supp. 131, 194 (D.C. D.C.C. 1982).

SBC, rather than retain the yellow pages publication operations within its telephone operating subsidiary, SWB, requested and obtained Commission authorization to remove yellow pages operations and place them in a separate subsidiary. Although originally performed by a different subsidiary, the yellow pages publications operations are now performed as Southwestern Bell Yellow Pages (SBYP).

SBYP also has a contract with SWB to publish SWB's official white pages directories. The contract includes the selling of "bold face" listings for white pages directories and directory cover advertisements. White pages directories contain alphabetized listings of SWB telephone customers and their telephone numbers. Where practical, white pages and yellow pages directories are combined, but in large metropolitan areas they are published separately. The directories include each SWB customer, both business and residential, and are distributed to all SWB customers.

Two basic issues are presented the Commission in this case concerning the costs and revenues associated with yellow pages directories. First is the issue of whether the cost and revenues of yellow pages should be imputed to SWB and used in determining SWB's revenue requirement. If imputation is found to be reasonable, the second issue is, what level is the proper level of costs and revenues to impute to SWB.

In the last complaint case against SWB, the Commission imputed yellow pages revenues to SWB and set them at the 1985 level with one adjustment for uncollectibles. 29 Mo. P.S.C. (N.S.) at 640-643. The Commission found the 1985 level to be reasonable based upon the assurances of SWB that the creation of a separate subsidiary to publish yellow pages directories would not harm SWB ratepayers. The Commission found that 1987 test year levels of revenues had dropped dramatically and the 1985 level should be maintained until SWB could show that a more current level of imputation would be appropriate.

Subsequent to the decision in TC-89-14 the Commission approved an experimental incentive regulation plan for SWB. This plan allowed SWB to retain earnings up to a 14.1 percent return on equity (ROE) and to share with ratepayers earnings above that level. SWB in this case has proposed the Commission make the experimental plan permanent, reduce the 14.1 percent ROE for sharing to 10.7 percent, and not impute yellow pages revenues to SWB. The reduced ROE would, in SWB's estimation, reflect the removal of yellow pages from SWB's revenue requirement calculation.

Staff proposes the Commission continue to impute yellow pages revenues to SWB and treat SBYP as a part of SWB's operations for ratemaking purposes. Staff's basic proposal is to retain the 1985 imputation found by the Commission in TC-89-14 to be reasonable. Staff has also proposed other imputation levels and adjustments to yellow pages revenues.

The Commission has already found that it could not merely accept the current sharing point of 14.1 percent ROE and make the experimental plan permanent. The Commission must first determine SWB's revenue requirement and set just and reasonable rates based upon that revenue requirement. The Commission, in reaching its decision concerning a reasonable revenue requirement, has established what a reasonable ROE for SWB is. (That ROE is discussed in the Rate of Return section of this Report And Order.) The Commission does not believe that it would now be appropriate to adjust that ROE 340 basis points and not impute the yellow pages revenues to SWB. The Commission finds that the proper ratemaking procedure is to determine an appropriate level of imputation for this case.

The Commission finds that imputation of yellow pages costs and revenues is in the public interest and reasonable. First, there is no question that the Missouri General Assembly has specifically granted the Commission the authority to impute the revenues and costs associated with yellow pages directories to SWB regardless of whether those directories are published by SBC or an affiliate such as SBYP. Section 386.330.4, R.S.Mo. (Supp. 1992). This statutory authority recognizes the importance of yellow pages operations to SWB's telephone operations and reflects a continuation of the findings made by the federal court in the AT&T divestiture case that retention of yellow pages operations by the RBOCs was in the public interest.

The Commission finds that yellow pages directories are an integral part of SWB's telephone operations and even though they are now provided by a separate subsidiary, they still retain their historical relationship to SWB's operations. Yellow pages directories are an adjunct to SWB's white pages and provide a valuable link between SWB customers. SWB's white and yellow pages have historically been perceived as the official telephone directories. This perception reflects reality since SWB lists all telephone customers in white pages and gives all business customers free listing in yellow pages. This is true even though SBYP publishes the directories.

Yellow pages directories are distributed to all SWB customers free of charge and the yellow pages are considered by customers as part of the "phone book". SWB witness Wilk, while a Commissioner of the California Public Utilities Commission, recognized that yellow pages directory services were a unique class of services that were developed at ratepayer expense. Commissioner

Wilk then found that the cost and revenues of yellow pages directories should be used in setting basic rates in California.

A review of the treatment of yellow pages by other RBOCs supports the decision to impute their costs and revenues. Six of the RBOCs, including SBC, created a separate subsidiary for yellow pages publishing. The other RBOC kept yellow pages as part of its telephone operations. Of the RBOCs with separate subsidiaries, all except SWB provide some form of compensation by the yellow pages subsidiary to the operating telephone company. SWB alone does not receive any compensation and, in fact, SWB pays SBYP for the costs of publishing, printing, and photocopying of the white pages directories. By this arrangement, the Commission finds that SWB's ratepayers are actually subsidizing SBYP profits while receiving no benefit from the use of SWB listings.

Imputation of costs and revenues will allow the ratepayers to receive a benefit from these services that have been developed at their expense. SWB could have entered into a contractual relationship with SBYP and its predecessors; instead, SWB chose to remove these ratepayer-provided services from SWB at no cost and to use them to generate profits for SBC. The Commission finds that ratepayers should receive a benefit from yellow pages and imputation is the statutorily authorized method of recognizing that benefit.

SWB has suggested that imputation is not necessary in this case because there will be no reduction in basic local rates, and the Commission should not impute yellow pages earnings in a case where SWB is not seeking a general rate increase or an increase in basic local rates. This proposal may have some superficial appeal but does not withstand scrutiny. First, under the rate design adopted in this case a substantial portion of the reduction will be used to reduce the rate of Touchtone service, which is an integral part of modern basic service. In addition, if the Commission follows SWB's logic, the entire amount of yellow pages imputation should go to reduce basic rates. Only one party has proposed this and the Commission does not believe there is necessarily a direct subsidy between yellow pages imputation and basic service. Imputation reflects the fact that yellow pages are an integral part of telephone service and by imputing yellow pages earnings, rates reflect the significant contribution yellow pages earnings make to SWB's operations and to maintaining rates at a reasonable level.

The Commission decision, additionally, follows its decision in TC-89-14. In that case the Commission referenced SWB's and SBYP's predecessor representatives' assurances that the creation of a separate subsidiary to publish yellow pages would not harm ratepayers, nor would imputation be prevented. The comments of those representatives of SWB and SBYP's predecessor, reflected their recognition that imputation was appropriate and that the creation of a separate subsidiary in no way affected the ability or authority of the Commission to impute those revenues. Perhaps at some point in the future yellow pages' significance to basic telephone service will be so diminished as to make imputation unreasonable. That time, though, is not now.

SWB has made the removal of the imputation of yellow pages a major part of its proposed alternative regulation plan. This proposal would allow SBYP, and therefore SBC, to retain revenues generated from Missouri ratepayers without any compensation being returned to the ratepayers. SWB has sought this same result through legislative efforts in the General Assembly. Because of SWB's position in this case and its legislative efforts, the Commission has reviewed this issue carefully and has considered the potential effect of adopting SWB's position. The Commission finds, based upon its review, that even though yellow pages is published by a separate subsidiary, customers still consider the white pages and yellow pages with SWB's name and logo as the official telephone book of the telephone company and rely upon it as an important part of the basic telephone service provided by SWB. Communication by telephone, of course, cannot be accomplished without the instrument and connecting wires and switches, but without the information provided in the white and yellow pages directories, the customers' access to other SWB customers would be significantly reduced.

Although SWB indicates that the yellow pages subsidiary is a well run company, it believes it faces increasing competition and that such competition will eventually require the elimination of imputation. SWB states that it is not seeking elimination of imputation in this case merely because of competition, but it believes the Commission, in reaching a decision on this issue, should recognize the significant competition it faces. SWB contends that yellow pages, in effect, competes with all forms of advertising, not just other yellow pages directories. Advertising media such as newspapers, television, radio, magazines and direct mail advertising, SWB contends, pose a substantial threat to yellow pages profits in what SWB sees as a diminishing advertising revenue market. Additionally, SWB points out that yellow pages revenues constitute only 7 percent of nationwide advertising revenues among all advertising media.

In addition to the competition from other forms of advertising media, SWB claims that it is subject to substantial competition from other yellow pages directories. This, though, SWB has been unable to substantiate since it has no information on revenues generated by other directories or, for that matter, by other advertising media.

Even though SWB had no market-specific information about the revenues of competitors, there was evidence in the record concerning customer usage of yellow pages. This information is found in Exhibit 195HC, page 32. Although SWB contends usage studies are of little value in determining whether competition exists from other directories, the Commission finds the results of the usage studies revealing. For the St. Louis and Kansas City areas, the study indicates the usage of other directories is remarkably insignificant. (Staff provided the results of the usage study for St. Louis in its brief. The Commission is not sure this information has been classified as public information and so will not reproduce those results in this Report And Order.) The study results show that in the other areas where competition exists, yellow pages dominates competitors.

Usage by customers is what businesses pay for when they buy additional advertising in SWB's yellow pages. The evidence concerning usage indicates that a business has no real yellow pages alternative to the SWB yellow pages directory for reaching customers. In TC-89-14 the Commission found that competition for yellow pages was not significant and the results of the usage study in this case show that competitors, especially in St. Louis and Kansas City, if present, have little customer acceptance. Even after several years of competition in the St. Louis and Kansas City areas, usage of other yellow pages directories are at levels that are almost insignificant. In those areas where a competitor has developed some customer recognition, such as Springfield, St. Charles, Cape Girardeau and Lake of the Ozarks, SWB still dominates the markets.

Additional evidence that yellow pages directories are subject to little direct competition is the continued strong profitability of yellow pages and the ability of SBYP to raise prices and maintain that profitability. In a competitive market, prices are driven to marginal costs and consistently higher returns such as those experienced by SBYP would not be realized.

The Commission finds that contrary to SWB's contentions, the evidence is that direct competition from other directories remains insignificant and competition from other advertising media is at best peripheral. In order to see the limitations of any other advertising media significantly encroaching on the yellow pages market, one need only ask: "Where do you look when you want to find the closest dentist, or a family health clinic? Where would you look if you wanted to find a computer store, catering service, construction company or restaurant?" These businesses advertise in the yellow pages because they know that each telephone customer receives a telephone directory and each customer knows that every business is listed in the yellow pages portion of that directory. Competition among businesses providing similar services generates yellow pages revenues while yellow pages, in reality, offers the only ubiquitous advertising medium for the businesses' services.

Since the Commission has found that imputation is appropriate, the issue concerning the appropriate level of earnings to impute remains. As stated earlier, Staff has proposed retaining the 1985 level ordered in TC-89-14 with some adjustments or the 1991 level with adjustments. SWB proposes using the level at September 30, 1992, with three adjustments.

Although a considerable volume of testimony and evidence has been adduced concerning the appropriate level of imputation, the Commission believes it should follow the findings in TC-89-14 in reaching a decision. In TC-89-14 the Commission found that imputation should be at the 1985 level to reflect SWB's promise that ratepayers would not be harmed by the creation of a separate subsidiary.

The evidence in that case showed that profits had declined in 1986 and 1987 but were increasing into 1988. The Commission found that the reduction in earnings for yellow pages was within the yellow pages subsidiary's control and therefore the test year levels were not appropriate for imputation. The Commission found, further, that the 1985 level of imputation should be continued until SWB could show some other level was appropriate.

The Commission has before it in this case the total revenues, expenses and contribution margin for yellow pages from 1985 through December 31, 1992. This information is reflected in the chart below found in Exhibit 200, page 52, and supplemented with information from Exhibit 202, page 14, for 1992 data.

	Revenues	Expenses	Contribution
1985 actual	$82.5 million	$33.4 million	$49.1 million
1985 adjusted	$76.6 million	$33.4 million	$43.2 million
(Report And Order, Case No. TC-89-14)			
1986	$69.1 million	$39.0 million	$30.1 million
1987	$72.8 million	$39.9 million	$32.9 million
1988	$88.0 million	$43.1 million	$44.9 million
1989	$88.9 million	$54.3 million	$34.6 million
1990	$96.7 million	$55.0 million	$41.7 million
1991	$101.7 million	$59.9 million	$41.8 million
9/30/92	$112.840 million	$65.756 million	$47.261 million
1992	$116.204 million	$65.509 million	$51.448 million

These results indicate that the operation of yellow pages as a separate subsidiary is reaching the levels contemplated by SBC in 1985. Revenue levels have increased steadily over 1985 levels since 1988. Contribution margins have varied but it appears that the 1992 contribution exceeds 1985 unadjusted.

Based upon these results the Commission finds that use of the 1985 contribution margin is no longer appropriate. The circumstances upon which the Commission made its findings in TC-89-14 are readily apparent in the above information for 1986 and 1987. Revenues were down, expenses were up and, as the Commission found, these levels were within the control of the publishing company.

The problems addressed by the Commission in TC-89-14 appear to have been resolved and the profitability of yellow pages has returned to expected levels. Staff's reliance on the 1985 results is understandable when the main thrust of SWBYP is to maximize its profits and therefore limit any amounts imputed to SWB. The problems with containing yellow pages profits, especially in light of SWB's representation to the Commission, strongly support that 1985 levels should be maintained until yellow pages operations appear to return to 1985 levels. This, though, the Commission believes has happened and so the Commission will look to more recent levels in finding the appropriate contribution margin.

The Commission finds that the level of imputation for yellow pages from September 30, 1992, more reasonably reflects ongoing operations. This brings the imputation level to the closest point in this case to the period when rates will be in effect. The September 30, 1992, level reflects the increasing net revenues and expenses of yellow pages. The results for year-ending 1992 reflect that the contribution margin continues to increase. Use of year-ending 1992 levels might be more appropriate but they are beyond the test year as updated and so would not reflect an appropriate matching of investment, expenses and revenues with the overall revenue requirement.

Since the Commission has found the September 30, 1992, contribution margin to be appropriate for imputation, there remain several adjustments to that contribution margin which need to be addressed. If the 1985 costs and revenues were adopted by the Commission, Staff proposed an adjustment to the uncollectible amount to reverse the decision of the Commission concerning uncollectibles in TC-89-14. Since the Commission is not adopting 1985 results, this issue need not be addressed.

Staff proposes an adjustment to the contribution level for yellow pages imputation to address affiliate transactions between SWB and other subsidiaries for printing services provided in the publication of white and yellow pages directories. These affiliates are Times Journal and Gulf Printing. Currently, SWYP publishes the white and yellow pages directories for SWB, and SWYP contracts with Gulf Printing and Times Journal to print these telephone directories. Staff asserts that the contracts between SWYP are not "arm's length" and so SWYP pays more for these services than necessary and thus increases its expenses, which reduces its contribution to SWB. Staff then asserts that SWB's contracts with Times Journal are not "arm's length" and therefore SWB has expenses that are higher than necessary on its books. Staff bases its adjustments on the awarding of the contracts in 1987 to Gulf Printing and Times Journal, which Staff's evidence indicates were not the low bidders.

The Commission agrees with Staff that these affiliate transactions raise concerns as to whether SWB is paying more than it should for the publishing and printing of yellow pages and white pages directories. The Commission, though, rather than make the adjustment proposed by Staff in this case will refer these matters specifically to the docket to be established to address affiliate transaction procedures and cost studies. This, the Commission believes, is the more appropriate way to ensure that SWB ratepayers are charged reasonable amounts for these services. As affiliate transactions, all services purchased by SWB from Times Journal, SBYP or other subsidiary will have to be based upon FCC costing procedures and any underlying contracts such as those between SBYP and Gulf Printing, will also have to follow those costing procedures.

Staff proposed certain adjustments to yellow pages' income statement based upon its position concerning the allocation of SBC costs. The Commission has addressed the SBC allocation issue in that part of the Report And Order, and adjustments to yellow pages costs should be made based upon the decision reached regarding that issue. The allocations from SBC to SBYP must be adjusted in compliance with the Commission decision to ensure expenses shifted in the decision concerning SBC allocations do not appear as expenses to SBYP to reduce imputation to SWB from SBYP.

Both Staff and SWB propose to remove business development expenses associated with nontraditional SBYP products and services, such as directory-delivered inserts and direct mail. This adjustment is adopted.

For the other two adjustments proposed by Staff, dues and donations and employee compensation, the Commission believes these are necessary and appropriate to reflect the full extent of the imputation process. Allowing SBYP to make contributions and pay dues and to include these in total expenses creates a subsidy by SWB ratepayers for contributions and dues that would not be allowed if SWB incurred the costs directly. For employee compensation costs found by the Commission not to be reasonable, there would, again, be a subsidy flowing from SWB ratepayers to the SBYP employees receiving those awards and incentives. Because of the imputation process, SBYP employee compensation expenses should reflect the decision made by the Commission regarding employee compensation for SWB.

In addition to Staff's proposed adjustment, SWB has proposed three adjustments to the September 30, 1992, contribution level. The business development adjustment is discussed above and is agreed to by Staff as reasonable. The other two adjustments are (1) to subtract certain white pages revenues and expenses from the yellow pages results, and (2) to adjust for a return on equity on SBYP investment in yellow pages operations.

SWB adjusted yellow pages imputation results by removing the revenues and expenses alloted to the white pages directory publishing agreement between SWB and SBYP. Under this agreement SBYP compiles, photocomposes, produces, prints, warehouses and distributes separate white pages directories and those that are co-bound with yellow pages directories. SBYP submits a bill to SWB for its share of these expenses and includes a two percent administrative fee. The agreement of the fee is calculated by taking two percent of the amount billed for white pages expenses. SWB claims that its financial results already include these expenses and the revenues and expenses related to the agreement should be removed from SBYP results before imputation to SWB.

Staff opposes this adjustment as an attempt to leave profits with SBYP. Staff asserts that it considers the two percent administrative fee in its consolidation of SBYP operations into SWB's operations for ratemaking. Using

Staff's approach, revenue to SBYP is an expense to SWB. Additionally, Staff believes it is unreasonable for SWB to pay an administrative fee when it should be receiving compensation for white pages rather than paying a fee.

The Commission finds SWB's proposed adjustment reasonable. Even though the revenue to SBYP from the white pages agreement, including the administrative fee, is an expense to SWB, the Commission finds that this expense should not be included in the imputation process. The Commission has already recognized that SWB receives no compensation from SBYP for use of white pages listings and therefore is imputing yellow pages revenues to SWB. This recognition compensates SWB for the development of yellow pages and white pages listings. To then include SWB's payments to SBYP as revenue appears to be a double assessment since imputation would bring the payment back to SWB. In addition, the agreement is an affiliate transaction and as such should be evaluated as an affiliate transaction.

The Commission also agrees with SWB's adjustment which allows an ROE on all SBYP investment. Historically, the imputation process focused on revenues and expenses associated with yellow pages publishing operations but has only allowed a return on any investment by including prepayments, which are largely deferred directory charges, in rate base. The effect of the deferred costs associated with prepayments can be seen on page 130 of Staff's initial brief. SWB contends the rate base treatment for prepayments does not allow a return on SBYP property, plant and equipment, accounts receivable and deferred directory charges. SWB proposes to include an ROE component for SBYP investment in computing the imputation level as of September 30, 1992.

Staff opposes this adjustment, mainly because a substantial amount of the investment relates to accounts receivable. Staff asserts that accounts receivable are not a part of rate base but are typically included in a cash working capital requirement by use of a lead-lag analysis. Staff explains that since the accounts receivable balance represents future cost payments, it includes reimbursement for many types of services, such as depreciation and deferred taxes, and includes a profit. Allowing the ROE adjustment would, Staff contends, allow a return on a profit, which is inappropriate. Staff suggests SWB perform a lead-lag analysis if it is not recovering a return on all investment.

Staff's main points in opposition to SWB's adjustment are derived from the traditional ratemaking procedures used to develop a revenue requirement for a regulated company. Staff's position on imputation is that SBYP costs, revenues and investments should be treated as if they were part of SWB. The Commission recognizes that this approach has merit and has followed this approach on some of the proposed adjustments. The Commission, though, is not convinced that acceptance of all traditional ratemaking treatment is appropriate in the imputation process.

Staff's evidence suggests that a lead-lag study should be performed instead of SWB's proposed ROE adjustment, since the investment upon which SBYP is seeking a return is accounts receivable. Staff then states that accounts receivable do not generate a cash working capital requirement. This appears to be a contradiction. Staff additionally raises questions about the calculations made by SWB witness Martin for the adjustment, and questions the overall inappropriateness of an ROE component for accounts receivable. Staff concludes by asserting that it has allowed interest expense in SBYP's costs, a practice which is not followed for regulated companies.

The Commission finds that regardless of the questions raised by Staff concerning SWB's adjustment for an ROE component in investment of SBYP, such an adjustment is reasonable. Imputation should bring a level of revenue to SWB which compensates it for the yellow pages directories business it developed. The imputation process need not strictly adhere to traditional ratemaking but should only set a reasonable level of contribution. The Commission finds that SBYP should be allowed a return on investment other than prepayments. This return should allow SBYP a return on the investment it has made in generating the revenue which is imputed. Perhaps there are better or more reasonable ways to calculate this return, but based upon the evidence before it, the Commission finds SWB's adjustment to be a reasonable approach to this matter.

Since the Commission has not found the 14.1 percent ROE proposed by SWB to be reasonable, the ROE component will have to be recalculated based upon the 11.72 percent ROE found to be reasonable for SWB.

Employee Compensation

A. Senior Management Incentives

Staff proposes a disallowance of incentive plans providing for payments to senior managers above the level of those employees eligible for TEAM awards. There are two plans, one which provides for short term incentives and another which provides for long term incentives. Staff proposes to disallow $1,009,000 in long term incentives for SWB-Mo and GHQ, and $810,000 in short term and long term incentives for SBC.

Short term incentives are based upon a one-year period. Goals are set by SBC's Human Resources Committee at the beginning of the fiscal year, and include customer service goals and net income target goals under a single matrix. A payment percentage is derived from the matrix and applied to a predetermined target award to calculate the incentive award. After achievement of these goals, incentives may be awarded from a discretionary fund for extraordinary improvements, with some limitations, based upon the recommendation of the SBC chairman.

Long term incentives are based upon a three-year period. Under the plan, performance units are assigned to participants at the beginning of each new three-year cycle, which begins each fiscal year. Each unit earned is payable in the form of SBC stock. Units granted are based on management responsibilities, and the value of the units awarded represents the target award for that participant. The actual net income of SBC achieved over the three-year period is compared to the commitment budget and an achievement percentage is calculated. The achievement percentage is then applied to determine the number of units actually earned and payable as incentives.

SWB argues that both plans put a part of total senior management compensation at risk, and that Staff's disallowance would require increasing base salaries, which in turn would drive up the cost of benefits. The focus on profit benefits both shareholders and customers, and SBC stock price reflects the present value of long term decisions and indicates how the market evaluates the managers of SBC and its subsidiaries. SWB also contends that its employee reductions and reorganizations demonstrate that the incentives are working. Finally, SWB disputes Staff's emphasis of Missouri-specific results, claiming that the use of such results would be impractical and costly to administer.

Staff states that short term incentives for SBC officers are computed by using SBC net income and SBC service measurement results. According to Staff, there must be a proximate nexus between an incentive plan and ratepayer benefit, and therefore the use of SBC results is not sufficiently linked to the provision of benefit to Missouri ratepayers to include the cost in Missouri rates. Staff's other arguments with respect to the short term SBC incentives are similar to its arguments concerning the long term SBC incentives, and need not be repeated here.

Staff also notes that the short term incentive plan for SWB-Mo was revised on January 1, 1991, to require that performance measurements be based 100 percent on Missouri net income and customer service results. In 1993 the plan for SWB-Mo was further changed to instead consider the composite performance results of the four Midwest states instead of 100 percent Missouri-specific results. Staff indicates that its allowance of short term incentives for SWB-Mo was based on the use of 100 percent Missouri-specific results as established in

1991, and that if the 1993 changes had been in effect within the test year as updated, it would have sought disallowance of the short term incentives for SWB-Mo as well.

According to SBC witness H. Richard Troy, Jr., the net income performance for SBC short term incentives is based 100 percent on SBC results, and the customer service component is based on a weighted average of telephone company and national subsidiary results, weighted according to the previous year's actual revenues. As a practical matter, the inclusion of Missouri-specific results is such a tiny portion of the SBC short term incentive calculation that Staff's argument remains essentially sound. As was stated by the Commission previously in Case No. TC-89-14, "In the Commission's opinion the results of the parent corporation, unregulated subsidiaries, and non-Missouri portions of SWB, are only remotely related to the quality of service or the performance of SWB in the state of Missouri. Achieving the goals of SBC and unregulated subsidiaries is too remote to be a justifiable cost of service for Missouri ratepayers." 29 Mo. P.S.C. (N.S.) at 627. As was suggested by Staff, Missouri could experience poor service but still be charged for the cost of short term incentive expenses because of the results of other entities. In addition, many of the arguments made by Staff with regard to long term SBC incentives apply with equal force to the short term SBC incentives. Thus the Commission is of the opinion that the short term incentives for SBC should be disallowed.

In 1991 the long term incentives were revised and the payment percentage was lowered from 190 percent to 150 percent, with 100 percent of the payment percentage based on SBC net income and the remaining 50 percent available for optional performance categories. The Commission has not been favored with any indication of what the optional categories may comprise and thus cannot speculate whether they would fall under the classification of financial results, customer service results, or another classification altogether.

Staff maintains that long term incentives for SWB-Mo, GHQ, and SBC should be disallowed because the plan focuses on financial results and does not consider service, and because the use of SBC financial results is not Missouri-specific. The structure of the plan provides an implicit incentive for participants to try to increase SBC's stock price. This in turn could encourage senior managers to spend a greater percentage of time on nonregulated companies and discourage time and effort spent on Missouri operations. Staff also indicates that the use of SBC objectives could actually hurt Missouri ratepayers to the extent that the objectives seek to implement the company's position on items such as Yellow Pages, FAS 106, and flotation costs, and retry issues that have been lost in the past under similar circumstances, such as short term TPUC, business meals, inflation adjustment, and COR/Salvage for pre-1981 property. In addition, Staff disputes SWB's claim that employee reductions indicate the incentives are working, contending that no link was shown between the incentives and the factors which influence downsizing, and that downsizing was a normal business decision.

The Commission is of the opinion that the long term incentives for SWB-Mo, GHQ and SBC, like the short term incentives for SBC, provide, at best, benefits that are too remote to be included in the cost of service for Missouri ratepayers. Particularly in the case of SWB-Mo and GHQ, the long term incentives may reward managers for results they did not achieve, based on results for which they are not directly responsible and over which they have limited control. Because the plan does not focus on Missouri-specific results and does not include service-oriented goals, the Commission concludes that it is not appropriate to include the cost of the plan in the cost of service. The likelihood of SBC managers emphasizing whatever they perceive will cause the market to react favorably to SBC stock, including giving priority to unregulated subsidiaries, further convinces the Commission that Missouri ratepayers should not fund the long term incentives.

The Commission finds that Staff's proposal to disallow the long term incentives for SWB-Mo and GHQ, and the short and long term incentives for SBC, is reasonable.

B. TEAM Awards

1. Services/GHQ TEAM Awards

The only issue remaining with respect to TEAM awards is Staff's proposed disallowance of the cost of nondiscretionary TEAM awards prorated to SWB-Mo for GHQ managers, also referred to as Services managers. TEAM awards were implemented in 1986 to recognize and reward management employees on the basis of group achievements related to customer service and financial objectives. SWB considers the TEAM awards to be part of the total cash compensation package for SWB management employees. The portion of the compensation package that is given as a TEAM award is considered compensation that is "at risk," i.e., if the award is not earned it is not received. The awards are given annually, and must be reearned every year. A target TEAM award is established for each eligible management salary grade. TEAM payments are calculated by applying performance results to a matrix to determine the payout percentage of the target TEAM award.

SWB contends that there has been no finding that its total compensation package is excessive, and that since the TEAM awards are part of that compensation package, they should be allowed. SWB also claims that Staff's disallowance of TEAM awards for GHQ managers is inconsistent in two respects: (1) it is inconsistent to allow TEAM awards for SWB-Mo managers, but disallow TEAM awards for GHQ managers, and (2) it is inconsistent to allow the base salary of GHQ managers, but disallow the TEAM awards for these same managers. In support of its contention that Staff's treatment of GHQ TEAM awards is inconsistent, SWB stresses that Staff has admitted that the centralized functions performed by GHQ employees provide benefits to Missouri, and that it is theoretically more efficient to have one GHQ person perform certain functions for five states than to have one person at each state performing these functions. SWB also points out that the Commission allowed the TEAM awards in Case No. TC-89-14.

Staff raises a number of arguments in support of its disallowance of the GHQ TEAM awards. Staff compares the GHQ TEAM awards to the short term senior management incentives for GHQ managers, and asserts that the TEAM awards for GHQ managers are deficient because they rely on performance measures for SWB's entire five-state operation, and are not Missouri-specific. Staff states that the short term senior management incentives were disallowed in TC-89-14, and that since the GHQ TEAM awards use the same performance measures, to be consistent the Commission should also disallow the GHQ TEAM awards. Staff also stresses that the TEAM awards which were allowed in TC-89-14 were not evaluated on the basis of individual entities, and therefore the Commission's action in that case is not binding on the issue in the present case. Staff also points out that SWB has stated in its initial brief that its earnings performance has declined annually since 1990. If true, and if GHQ TEAM awards are actually performance-based, then these faltering performance results indicate that no bonuses are deserved. In addition, Staff notes that GHQ no longer exists due to reorganization by SWB, and that the continual reorganizations make it hard for employees to recognize who they work for and what their goals are. Staff also claims that the Commission may reach its own conclusions as to whether SWB's total compensation package is excessive by reviewing Exhibit [illegible].

Staff also notes that the TEAM award plan for SWB-Mo was revised in 1993 to consider the composite performance results of the four Midwest states instead of 100 percent Missouri-specific results. Staff indicates that its allowance of TEAM awards for SWB-Mo was based on the use of 100 percent Missouri-specific results, and that if the 1993 changes had been in effect within the test year as updated, it would have sought disallowance of the TEAM awards for SWB-Mo as well.

The Commission is aware that the arguments raised by Staff with respect to TEAM awards in TC-89-14 are different than the arguments raised in this case, such that the issue of the propriety of TEAM awards for a given specific entity has not been clearly addressed. However, the Commission has held that the TEAM award "is not a bonus or additional compensation for superior performance but is a substitute for expected increases in base salary which in recent years have been exchanged for the TEAM award which must be reearned every year." 29 Mo. P.S.C. (N.S.) at 626. The TEAM awards should not be viewed as necessarily identical to the short term senior management incentives, as SWB witness Connie J. Wepfer explains, "GHQ TEAM awards are a component of management base compensation just like SWBT-Mo TEAM awards; they are not <u>senior management incentives</u>." Exhibit 43, p. 14. (Emphasis original). The Commission finds that the disallowance of TEAM awards for GHQ managers, where the base salary is allowed, has not been sufficiently justified. While it may be possible to devise Missouri-specific goals for GHQ managers, the grant of TEAM awards for the attainment of performance goals that reflect consolidated functions performed by GHQ managers is not inappropriate. The Commission also declines Staff's invitation to delve into the excessiveness or reasonableness of SWB's total compensation package based on Exhibit 15P. This proprietary exhibit was offered into evidence for the Commission's consideration with respect to the proposed incentive regulation plan, and although it may contain information useful to an assessment of SWB's compensation level, the issue was not specifically developed in the testimony or at the hearing on this matter.

The Commission is of the opinion that the record does not support the reasonableness of Staff's proposed adjustment for GHQ TEAM awards, therefore the Commission will reject the proposed adjustment.

2. TEAM Annualization

SWB and Staff dispute the proper annualization of TEAM award costs to be included in the cost of service. SWB seeks to use 1992 calendar year accruals for TEAM award costs, while Staff proposes to use the actual amounts of TEAM payments paid out in 1992 for the 1991 performance year, less the amount of TEAM awards paid to employees who retired under the Enhanced Management Pension (EMP) plan. SWB does not dispute that TEAM awards for EMP participants should not be included in the cost of service.

SWB contends that Staff's use of the actual payout amounts for 1992 is inconsistent with the Commission's acceptance of GAAP and accrual accounting in Case No. TC-89-14, and points out that all of Staff's other wage and salary adjustments except for the TEAM and senior manager incentive adjustments are made on an accrual basis. SWB also alleges that use of the 1992 performance year is reflective of September, 1992 salary and employee levels, while Staff's use of 1992 payments for the 1991 performance year does not maintain the appropriate revenue/expense/rate base relationship, and therefore SWB's annualization is more reflective of ongoing operations.

Staff explains that it used actual 1992 payouts for the 1991 performance year rather than 1991 accruals for several reasons. The TEAM accruals for 1991 were higher than the payments for the 1991 performance year, and accruals for a discontinued program -- the Key Contributor Award (KCA) Program -- were embedded in the 1991 accruals for TEAM awards. Staff did not use 1992 calendar year accruals for performance in 1992, as these accruals are outside the test year period as updated to September, 1992. SWB's use of 1992 calendar year accruals, Staff maintains, is outside the test year period as updated and will distort the revenue/expense/rate base relationship. Staff also asserts that SWB has not offered any evidence to support use of its proposed accrual method, nor an explanation of why it disagrees with Staff's use of an actual method. In addition, Staff argues that if the Commission looks outside the test year by accepting SWB's annualization of the TEAM awards, the Commission should also exclude the entire TEAM awards from the cost of service, as the Commission would then be required to consider the 1993 changes to the TEAM awards which change the performance measurements for SWB-Mo TEAM awards from Missouri-specific results to the composite performance results of the four Midwest states.

The Commission is of the opinion that it cannot adopt SWB's annualization based on 1992 calendar year accruals, as the accruals in part occur outside the test year as updated, and therefore do not provide proper matching for the revenue/expense/rate base relationship. The Commission also determines that Staff's use of actual 1992 TEAM award payouts for the 1991 performance year rather than the use of 1991 accruals is appropriate, especially in light of the fact that the 1991 accruals included costs for a discontinued program. The Commission finds that Staff's annualization of the cost of the TEAM awards is reasonably representative of these costs on a going-forward basis.

C. Expense Percentage

SWB and Staff disagree over the calculation of the expense percentage. The expense percentage is a ratio applied to the total annualized payroll costs to determine the amount of payroll expense includable in the cost of service. For purposes of cost of service, payroll costs can be either charged to expenses or capitalized, or charged below the line. Generally, payroll costs related to operating and maintenance activities are expensed in the year in which the costs are incurred, while payroll costs related to construction activities are capitalized as plant in service and expensed over the life of the plant. The ratio actually reflects the percent of expensed payroll in proportion to the total payroll costs.

Staff developed three separate expense percentages for the 12-month period ending September 30, 1992, for SWB-Mo payroll, for GHQ payroll, and SWB-Mo and GHQ payroll combined. Staff's calculation factored in an 8.3 percent decline in SWB-Mo's capitalized payroll for the 12 months ending September 30, 1992, due to decreased construction activity, which was partially offset by a 5.1 percent decrease in expensed payroll for the same period and which increased the overall expense percentage only slightly from the 1991 test year to the 12 months ending September 30, 1992. In addition, Staff included a GHQ proration percentage decrease for non-state-specific GHQ salaries from 16.12 percent for the 1991 test year to 16.09 percent for the 12 months ending September 30, 1992. Further, Staff excluded the negative balances of three clearing accounts from its calculation of the total payroll costs and ultimately arrived at an expense percentage of 87.84 percent. The three accounts are Account No. 8705 -- Clearing; Account No. 8710 -- Clearing; and Account No. 9708 -- Custom Work Order (CWO).

SWB argues that costs are continually charged to and cleared from the CWO account as projects are undertaken, so that for any given 12-month period there will always be a balance in the account and therefore the assumption of Staff's witness that the CWO clearing account clears to zero on a calendar year basis is incorrect. SWB also contends that this is a continuing activity and that its expense percentage reflects the ongoing nature of the CWO activity. In addition, SWB charges that Staff has not considered the decrease in charges for CWOs from $3.7 million for 1991, to $1 million for the 12 months ending September 1992, to $0.5 million for the calendar year 1992, to $0.1 million for the first five months of 1993. The result of using Staff's expense percentage, according to SWB, is to understate SWB's expense percentage and thereby lower SWB's revenue requirement.

Staff's position is that it excluded the costs charged to the three clearing accounts to reflect a zero level which is representative of ongoing operations. Staff indicates that the exclusion of the three accounts is appropriate because the ongoing level of costs will be close to zero on a calendar year basis, as the clearing accounts merely hold the costs for a period of time until the costs are cleared out to other accounts. The $1,279,000 in these three accounts is embedded in SWB's total payroll costs and the negative balances in these accounts understate the total payroll and overstate the expense percentage. In addition, Staff maintains that the only items which should be used to compute an expense percentage should be expenses and capital costs, and that the effects of nonoperating accounts should be removed from the expense percentage calculation to properly reflect payroll expense on the income statement. Staff also adds that SWB's claim that CWO is a continuing activity and thus its charges should be included in the expense percentage calculation is misleading because the level of costs charged to CWO on an annual basis is irrelevant, in that the account balances for CWO and the other clearing accounts are not included in SWB's financial statements. Therefore, nonoperating items which are neither expensed nor capitalized should be excluded from the expense percentage. Thus, SWB has overstated its calculation by including the balances of nonoperating clearing accounts and the CWO account.

The Commission is of the opinion that whether or not the costs in the three clearing accounts are cleared to zero on a calendar year basis, the accounts ultimately do reflect a zero level which is representative of ongoing operations, as the accounts are eventually cleared out to other accounts. The CWO account in particular provides for the segregation of costs which SWB can expect to recover from third parties who request the custom work rather than from the ratepayers as a whole. Its inclusion in the calculation of the expense percentage is particularly inappropriate. The Commission determines that the costs contained in these three accounts are embedded in SWB's total payroll costs and that just as the accounts are not included in SWB's financial statements, so they should not be included in the calculation of the expense percentage.

The Commission finds that Staff's calculation of the expense percentage is more appropriate than the calculation by SWB and should be used to determine the amount of payroll expense includable in the cost of service. In addition, it is apparent from the reconciliation filed by the parties that SWB and Staff disagree on the quantification of the value of this issue. As the Commission has found in favor of Staff on this issue, it is consistent to use Staff's figure to quantify its value; therefore, the Commission adopts Staff's figure.

D. Severance Payment Plan

The Severance Payment Plan (SPP) replaces an older program, the Supplemental Income Protection Program (SIPP). SIPP was initially negotiated with the Communications Workers of America, AFL-CIO, CLC (CWA) by AT&T, on behalf of itself and the Bell Operating Companies, in 1977. SIPP was a response to CWA's concerns regarding employment security, and provided financial protection for a specific period of time to pension-eligible surplus employees willing to retire who were declared surplus due to technological change and changes in operations. SIPP was amended in 1980 to expand eligibility to certain surplus employees who did not qualify for a service pension, and again modified in 1983 to further increase the number of eligible surplus nonmanagement employees. SIPP was replaced in June of 1992 with the new SPP plan.

Payment under the SPP is based on job title and continuous service. The plan consists of three components: (1) Reassignment Pay Protection Plan (RPPP); (2) voluntary severance payments; and (3) involuntary severance payments.

SWB would generally first attempt to transfer surplus employees to vacant positions in other work groups to eliminate the surplus. The RPPP would compensate employees who transfer to a lower-paying position. If a surplus continues to exist after attempts to relocate the employees, the company would offer surplus employees voluntary severance payments to terminate employment. Any remaining surplus employees who do not voluntarily terminate employment may be laid off to eliminate the surplus, and would be provided with the involuntary severance payments.

The SPP plan is nearly the same as SIPP with the exception of the RPPP component, which was not a part of SIPP. SIPP was in effect during the 1991 test year, and was replaced with the SPP plan in June of 1992. SWB has included in the cost of service the expenses for SIPP and SPP for the twelve months ending September 30, 1992.

The arguments presented by SWB and Staff are somewhat similar to some of those made with respect to SWB's Enhanced Management Pension (EMP) and Enhanced Pension (EP) plans, discussed *infra*. SWB asserts that SIPP assists in work force adjustments due to technological change and competition, and the short term costs result in ongoing savings and reduce the cost of service. SWB also claims that SIPP expense levels provide a good surrogate for the costs associated with the new SPP plan, and that including SIPP costs matches the expenses with the embedded savings, and recognizes the recurring nature of the expense. In addition, SWB maintains that Staff's claim that SIPP expenses should be removed from the cost of service because the wages associated with future SIPP recipients are included in Staff's wage annualization is inconsistent. According to SWB, the SIPP expense is for employees who have already been terminated, and the wages of these employees have been excluded from both Staff's and SWB's wage and salary annualization. Specifically, the September 1992 employee level excludes recipients of SIPP payments between January and September of 1992, and therefore the future savings associated with those employees have been included in Staff's payroll annualization. Thus, Staff captures the future savings associated with the SIPP expense without allowing recovery of the reasonable costs associated with the savings.

Staff rejects SWB's methodology because ongoing costs should not be included in the cost of service without future savings. Since the calculation of a revenue requirement involves the inclusion of a representative level of expenses on a prospective, going-forward basis, a proper matching of savings with expenses would require a separate adjustment beyond the adjustments made to annualize the salaries to September 1992 levels. However, the quantification of the adjustment necessary to prevent double-recovery would be unmeasurable, as the number and identity of future SPP plan recipients is unknown. Staff also contends that employees cannot receive both severance pay and regular compensation at the same time, and that SWB's position on this issue does not allow benefits to accrue to ratepayers, as SWB's rates are not reduced automatically as future wage savings are generated.

The Commission is of the opinion that the expenses of SWB's SPP plan should be allowed. The SIPP/SPP plan is an old, ongoing program, not designed for a specific downsizing effort, but instead designed to recognize the likelihood of certain jobs being made redundant through technological change. The SPP plan differs from the EMP and EP plans in that this program is still in existence. There has been no claim that the expenses of SIPP are not a good surrogate for SPP costs, and the expenses fall within the test year as updated. The Commission therefore determines that it is appropriate to include the SIPP/SPP expenses in the cost of service.

E. Enhanced Management Pension and Enhanced Pension

SWB seeks to include in rates the costs for two voluntary force reduction programs which offered pension enhancements to eligible employees who elected to resign or retire under the provisions of the programs. The programs consist of an Enhanced Management Pension (EMP) plan for management level employees, and an Enhanced Pension (EP) plan for nonmanagement employees.

The EMP plan was implemented during the fourth quarter of 1991, and provided for the expansion of pension eligibility through the addition of five years of age and five years of net credited service for purposes of computing the pension amount. In addition, participants who retired with a service pension or resigned with a deferred vested pension on December 30, 1991, received an additional 15 percent supplement payable for five years, and/or an option of taking the present value of all pension benefits as a lump sum. Participants were required to leave the payroll by December 30, 1991.

The EP plan was negotiated with the Communication Workers of America, AFL-CIO, CLC (CWA) in March of 1992, and was made available to eligible nonmanagement employees for a period between April 15, 1992, to May 15, 1992. This program expanded pension eligibility and provided enhanced pension payments to enlarge the opportunity of nonmanagement employees to retire. In addition, the EP plan was also offered to surplus employees and certain employees in nonsurplus work groups to create vacancies into which surplus employees could be moved. Employees electing to participate in the plan had to remain on the payroll through June 6, 1992, but had to retire no later than December 31, 1992.

SWB contends that the expenses associated with the EMP and EP programs are recurring, as part of ongoing work force adjustments, and Staff's contention to the contrary is inconsistent with SWB's recent history. According to SWB, Staff's position on this issue allows Staff to take full advantage of the lower 1992 wage and salary expenses resulting from its use of September 30, 1992, employee levels, which exclude EMP and EP participants, without allowing recovery of the costs which directly resulted in the decreased expense. SWB also points out that it is not seeking recovery of the programs' costs on a yearly ongoing basis, but only to amortize these costs and reasonably recover the expenses associated with the wage and salary savings. A three-year amortization period was chosen to coincide with the experimental incentive regulation plan period. The proposed three-year amortization normalizes the activity to be included in the cost of service, and SWB maintains that the level of EMP and EP costs included reflects a representation of the average cost of all force reduction plans between 1986 and 1992. In addition, SWB also disputes the validity of Staff's argument -- discussed in further detail below -- that these costs were included in the 1992 customer credit calculation under the experimental incentive regulation plan, and thus were already recovered, stating that Staff has conceded that the main reason customer sharing of 1992 revenue was precluded was the booking of Right-To-Use fees.

Staff claims that since the EMP and EP programs have expired, with no firm plans to reinstate them in the near future, the costs of these plans are not known and measurable, but are speculative, and since any similar future program will be well beyond the September 30, 1992, update period, this unknown force reduction program would be an isolated adjustment that would violate the appropriate revenue/expense/rate base relationship. Staff also quotes SWB's response to a data request: "SWBT currently is not planning any force reductions of the magnitude of our previous programs." In addition, Staff alleges that future EMP and EP costs are incurred in lieu of payroll built into the cost of service. Thus, future EMP or EP costs would be offset by the future elimination of salaries and wages for those employees. SWB's proposal to include both the wages and salaries of current employees, as well as the costs attendant with the reduction of that employee level, overstates SWB's cost of service and thereby attempts to overcollect its costs from the ratepayers.

Staff also claims that the EMP and EP costs have already been recovered from the ratepayers, as the entire level of EMP and EP expense was considered by SWB in its development of the 1992 level of customer credits under SWB's experimental incentive regulation plan, and thus building these costs into rates is an attempt to collect these costs from the ratepayers twice. According to Staff, SWB used the EMP and EP expenses, along with the 1992 level of Right-To-Use fees, to determine that no customer credits were required in 1992. Staff also alleges that SWB earned above its authorized return on equity as set in Case No. TC-89-14, after a full consideration of EMP, EP, and Right-To-Use fees. Staff also suggests that SWB's proposal to amortize the costs of the EMP and EP plans is internally inconsistent, as amortization is usually used for extraordinary events, and not events that are recurring in nature. Thus, the amortization of EMP and EP costs confirms that SWB is not treating these costs as recurring. Staff adds that it prevailed on an identical issue in TC-89-14.

The Commission finds that the EMP and EP programs have expired and have not been replaced with new programs, and thus any potential future plans are too speculative to be the basis for maintaining in current rates the cost of terminated plans. There is little question that SWB has engaged in a number of employee reduction efforts in recent years. The Commission is not convinced, however, that downsizing will continue, or at least not at the level of the recent past. Downsizing can rarely be maintained at a high level indefinitely in an otherwise healthy company. As Staff pointed out in its direct testimony, it may take several years to build up a large enough number of experienced employees to qualify for early retirement, since a great number of eligible employees were eliminated by the recent EMP and EP programs.

The Commission is further of the opinion that SWB is treating and has treated these costs as extraordinary expenses, as suggested by Staff. In addition to its proposal to amortize the EMP and EP costs over a three-year period, SWB has also treated these costs as extraordinary expenses for purposes of calculating employee payouts under its short term Senior Management Incentive Plan and TEAM Award Plan. In calculating the financial results upon which payouts under the plans are based, adjustments may be made to reflect any extraordinary changes which significantly alter the basis upon which performance levels are measured. Exhibit 180HC shows such an adjustment for the nonmanagement Enhanced Pension Plan, and Exhibit 179P makes a similar adjustment for a "4th quarter charge for voluntary retirement program...." for the 1991 performance period. The Commission is aware of only one voluntary retirement program occurring during the 4th quarter of 1991 -- the EMP program. In any event, the EMP costs were treated similarly with respect to TEAM Award payouts. In Schedule 2-9 attached to the direct testimony of Staff witness Tim L. Tunks, a SWB manager explains in a letter to 1991 GHQ TEAM Award recipients that, "To make the awards as fair as possible, the costs of refinancing our debt at mid-year and the cost of implementing EMP were not used to compute the TEAM Award." Exhibit 175 (emphasis original).

Because there is no persuasive evidence that the expenses associated with the EMP and EP programs are recurring in nature, the Commission determines that it is not appropriate to include these expenses in the cost of service.

F. Stock Plans

SWB seeks to include in rates the estimated annualized costs for two programs which provide an opportunity for additional compensation to certain management and nonmanagement employees based upon the appreciation in price of SBC stock. The programs consist of a Stock Value Appreciation (SVA) plan for eligible first and second level managers, and a Success Sharing Plan (SSP) for eligible nonmanagement employees.

The SVA plan was implemented in July of 1992 and provides for an award of SBC restricted stock to eligible managers based upon an increase in the average price per share of SBC stock. SVA creates a committee which establishes a target price for the stock; if the average price of the stock equals or exceeds the target price for thirty consecutive calendar days, an award of restricted stock is made. The committee also establishes the amount of the award, which may not exceed 200 percent of the employees' target TEAM award for that year. The initial award amount was set at 50 percent. The initial target price was met in January of 1993, and restricted stock in the amount of $3,111,000 was distributed in April of 1993. SWB contends that this amount is known and measurable. A new target price of $90.00 per share has been set -- adjusted to $45.00 per share due to a stock split in May of 1993 -- and a new target award of 100 percent of the TEAM award has also been set.

The SSP plan was implemented in August of 1992 as the result of a collective bargaining agreement with the Communications Workers of America, AFL-CIO, CLC (CWA). A cash payout amount is determined by multiplying a factor called a multiplier times a predetermined compensation target. The multiplier is based on each full percentage point increase in the price of SBC stock that is more than two percent but less than ten percent, calculated over a period of one year. The maximum compensation target is computed by calculating the average daily basic wage rate times five for 1993, four for 1994, and three for 1995, then multiplying that equivalent cash amount by the highest possible multiplier, eight percent. The maximum payout for 1993 would be $359.00 per eligible full-time employee, with the payout date scheduled for September of 1993.

SWB maintains that the stock plans were established within the test year as updated, and it began to accrue the associated expenses in accordance with GAAP and Part 32, and therefore the expense should be annualized and included in the cost of service so as to properly quantify wage and salary expense. SWB also alleges that both plans encourage employee contributions toward productivity and profitability, and will benefit customers by stimulating employees to take a personal interest in the financial health of the company by meeting customer expectations, and by building a knowledgeable and dedicated work force, which is a necessary prerequisite to the delivery of exceptional customer service.

Staff counters with three main arguments in support of its proposed disallowance. First, both plans are isolated adjustments outside the test period as updated, in that the expenses are not known and measurable; accrual for the SVA plan began in August of 1992, but the expenses associated with the program would not be known and measurable until April of 1993, while accrual for the SSP plan began in September 1992, but the expenses associated with the program would not be known and measurable until September of 1993. Further, the estimated annual costs for SVA and SSP are not based on any known and measurable data.

Second, there is no accurate method to determine the cost of the plans on a going-forward basis, as there are numerous factors beyond the control of SWB or its employees which affect the price of SBC stock, including interest rates and overall trends in the stock market, as well as market reaction to unregulated business ventures, such as SBC's venture in Mexico. Representative costs cannot be reliably calculated because of the uncertainty involved. If estimated costs are built into rates and there is no increase, or there is even a decrease in SBC stock for a given year, SWB will have been compensated by ratepayers for expenses it had not actually incurred. This scenario is not unlikely, as it cannot be assumed that SBC stock will continually appreciate, but even if it did, the level of appreciation could still not be predicted in advance.

Third, stock price is not an accurate measure of the performance of SWB-Mo and GHQ employees. This is so because of the other factors involved in stock appreciation. Even an increase in SWB profits and high quality customer service is unlikely to have a substantial impact on stock price; therefore, the stock appreciation plans provide no real incentives for employee improvement, and Missouri ratepayers will not benefit from increased profitability and better customer service as claimed by SWB.

Staff also counters SWB's contention that the costs of the plans should be recovered in rates because accrual accounting is consistent with Part 32, which was adopted by the Commission in Case No. TC-89-14. Staff asserts that SWB is reading the Commission's decision in TC-89-14 too broadly and that the acceptance of Part 32 does not mean all accruals are accepted. In fact, Staff points out, Part 32 itself provides for an account to book variances from Part 32 created by regulatory decisions, at 47 C.F.R. § 32.1500 (1992). In addition, Staff maintains that accrual of an expense does not eliminate the requirement that the expense be known and measurable, but even if the costs of the plans are known and measurable, SWB fails to include potentially offsetting revenue increases or expense decreases in order to maintain an appropriate revenue/expense/rate base relationship.

The Commission finds that the costs of the SVA and SSP stock appreciation plans are not known and measurable as of the end of the test year as updated, and the costs of the plans are not appropriate for inclusion as isolated adjustments because such inclusion would distort the revenue/expense/rate base relationship.

C. Other Payroll Issues

Based upon the briefs of SWB and Staff, the only other payroll issue is apparently the March 1, 1993, management salary increase, discussed infra.

Since the Commission is unable to locate any evidence of what this issue is intended to include, no adjustment can be allowed or disallowed. From the reconciliation it appears that the quantification of the value of this issue may be related to the expense percentage ratio. SWB and Staff disagree on the quantification of this issue. To be consistent with its decision on expense percentage and acceptance of Staff's quantification of the value of that issue, the Commission will also accept Staff's quantification of this issue.

H. <u>Yellow Pages Payroll Adjustment</u>

This issue is discussed in the section of this Report And Order addressing Yellow Pages, *supra*.

I. <u>March 1, 1993, Management Salary Increase</u>

SWB proposes a pro forma adjustment to include as an expense the annual effect of a March 1, 1993, management salary increase in its cost of service. SWB claims that the increase has occurred and is therefore known and measurable, and that no additional revenue will be generated from the increase. Staff contends that inclusion of the increase will distort the revenue/expense/rate base relationship, and is outside the Commission's ordered test year update. Staff also maintains that although the salary increase may not directly cause an increase in revenues, other items may offset this expense.

The Commission is of the opinion that the March 1, 1993, management salary increase is an isolated adjustment beyond the test year update which is not appropriate for inclusion in SWB's cost of service. For an isolated adjustment to be appropriate, it must meet the requirements that the proposed adjustment must have occurred, must be measurable, and must be documented. Staff's testimony that the number used by SWB is not known and measurable because SWB's recent reorganization altered the prior situation where there were

Missouri-specific employees and Missouri-specific GHQ employees has merit. Whether the amount of salary increase sought to be included by SWB is related to the actual number of managers attributable to Missouri is open to speculation. In addition, an isolated adjustment must also be consistent with regard to the matching of revenue, expense, and rate base. Uncertainty about whether an adjustment is measurable adds to the difficulty of establishing proper matching.

Ordinarily, a change which occurs in the normal course of business does not allow for accurate matching. Examining other items does not provide an answer, both because of the time constraints on Staff in auditing the company and preparing its case, and because the effect is to create a new test year. At some point a line must be drawn and heeded; otherwise, the concept of a test year becomes eviscerated. The Commission determines that the situation presented by the salary increase is an ordinary occurrence in the normal course of business and does not provide for proper matching. Although isolated adjustments may be allowed under proper circumstances, the circumstances must be much less speculative in terms of matching than are presented here.

The Commission also notes that in many other issues presented for the Commission's decision in this case, SWB argues that there is a strong link between salary and other compensation and benefits, and performance, in terms of both quality of service and profit. Utilizing SWB's line of reasoning, it would not be unexpected for the salary increase to spur SWB's managers to increase efficiency and generate new revenues. Thus, the justification for considering the management salary increase in isolation is not well founded.

J. Compensated Absences

SWB contends that as a result of the adoption of Part 32 for ratemaking treatment in Case No. TC-89-14, SWB was required under 47 C.F.R. § 32.24 (1992) to record as a liability the expense for compensated absences in the year in which the benefits were earned by its employees, and to book as a deferred charge and amortize over a ten-year period the liability existing for the year of the changeover. Staff's position is that the amortization expense should not be part of the component cost of service, and seeks to exclude this amount.

In 1988 SWB converted to the form of accounting for compensated absences required by Part 32. SWB thus amassed in the year of conversion two separate liabilities for compensated absences: (1) the liability for vacations earned in 1988, which were taken and paid for in 1989, and (2) the liability for vacations which were taken and paid for in 1988, but which were unrecorded in 1987 because the new method of accounting was not in use at that time. This latter liability is sometimes referred to as the "catch-up" liability, and it is this amount which is being amortized over a ten-year period.

Staff argues that inclusion of the amortization builds into the cost of service an amount which SWB will never pay unless it goes out of business. SWB claims that Commission action disallowing the amortization expense would result in the requirement that the remainder of the deferred charge be written down under FAS 71. Staff concedes that technically the deferred charge would have to be written down, but claims that in practice this is seldom done. SWB complains that Staff has not proposed to recognize the financial impact of writing off the deferred charge. Staff admits that the write-off would be a one-time charge to expense, but appears to imply it is not a real charge.

The Commission is of the opinion that the amortization seeks recovery of an expense which was paid out in 1988, and that an actual cash transaction occurred. Staff's reasoning is unpersuasive, both because the recovery of an expense should not be inextricably linked to the viability or nonviability of a company in the future, and because Staff's logic could be extended to other areas in which there is a changeover to an accounting method which records a liability in one year for expenses to be paid in the future, with a resulting "catch-up" liability, regardless of the individual merits of using that type of accounting method in a given case. In addition, there is no reason why Staff's complaints concerning the amortization of the "catch-up" liability could not have been raised in Case No. TC-89-14, at a time when the issue of the adoption of Part 32 for ratemaking treatment was before the Commission for its decision. Thus the Commission determines that the amortization expense for compensated absences should in this instance be allowed in the cost of service.

Business Meals

Staff proposes to disallow the entire amount of SWB's business meals expense from the cost of service calculation. Staff bases its proposal on a review of four internal audit reports of employee expense account reimbursements for SWB, and contends that SWB has not corrected the problem of a lack of proper controls, which led to the Commission disallowing the entire amount of business meals expense in Case No. TC-89-14. SWB counters that the situation was made to appear worse than it really was in TC-89-14, and in essence attempts to revisit the Commission's decision in that case. SWB also attempts to compare one portion of one of the four current audits with three audit reports from TC-89-14, and contends that its current error rate is only 1.7 percent.

While Case No. TC-89-14 may provide a benchmark for comparison, the crucial question is what the situation has been in the more recent past. The Commission has extensively reviewed all the testimony and exhibits relating to this issue and finds the record made by Staff and SWB to be less than satisfactory. The only direct evidence presented of controls in place at SWB is found in Exhibit 7, Schedule 13, which consists of a copy of "Management Employee Expense Guidelines" ([illegible]), and Exhibit 47, a copy of a sample Employee Expense/Relocation Expense Reimbursement Form. There was also testimony that nonmanagement employees were subject to a per diem amount of approximately $23 to $25 per day, depending upon circumstances such as the time of day the employee started.

The sample expense reimbursement form by itself indicates little, as it is dated March of 1983, and presumably was in existence at the time TC-89-14 was decided. Brief references were made in the testimony to Operating Practice No. 56 (OP 56) -- which the Commission gathers may contain, among other things, instructions for filling out reimbursement forms -- but the Commission was not provided with a copy of this document and thus can only speculate as to what controls it might contain. The amount requested by SWB for business meal expense is not segregated between management and nonmanagement employees, and in any event there is no indication of what circumstances would permit a nonmanagement employee to receive a per diem allowance.

The Commission has reviewed the MEBG guidelines and is of the opinion that the language used is in many instances more descriptive of a goal than of a requirement. Company practice can be established by an officer of a particular salary grade or above, and the final disposition of any deviations in vouchers found by the Controller Organization is left with the management in the employee's department. The Commission has also reviewed the calculation of SWB's claimed 1.7 percent error rate, and finds the methodology used to be unpersuasive and the result not creditable.

After a thorough review of the four internal audit reports, the Commission is convinced that although controls may exist, they are either not being implemented or are inadequately enforced. The four audit reports are contained in Exhibit 44P, which under the Commission's Protective Order has been deemed a proprietary exhibit. The Commission has reviewed all of the evidence on the issue of business meals and concludes that it cannot articulate its decision thereon without reference to this exhibit. The function of a Protective Order is to protect proprietary and confidential information from unnecessary disclosure, not to insulate a utility from unfavorable evidence. Nevertheless, the Commission will endeavor to utilize only as much detail as is necessary to adequately support its decision.

The audit reports state that some wrongdoing has occurred; blank vouchers were signed; amounts and types of expense did not comport with MEEG guidelines; the number of home location business meals may have been excessive; inadequate explanations and supporting documentation for tax purposes may exist in a number of areas; documents were processed without proper authorization; controls for duplicate payments were inadequate; no explanations or justifications were given for expenses which would fall under the category of special or unusual circumstances; activity and follow-up on reports and reconciliations were not consistently performed, or were not performed on a timely basis; and logs of blank and used manual drafts were not maintained, creating a situation where blank drafts might be removed and result in financial loss. Error rates for specific deficiencies range from 2 percent to 96 percent. By far the biggest problem, and perhaps a good synopsis of the above-listed deficiencies, was a failure to follow procedure.

The audit reports listed a number of recommendations, some pertaining to the problems already mentioned. In addition, one report recommended that the company develop a clear company position on the propriety of celebrations for various purposes, including dinners for retirements, personnel changes, and recognition dinners, sometimes with spouses in attendance. The report indicated that no clear policy existed allowing, prohibiting, or giving guidance on the propriety of these expenses. According to another report, the MEEG guidelines have not been issued to SWB personnel nor incorporated into SWB practices. The report noted differences between the MEEG guidelines and the SWB guidelines, and concluded that the conflicting guidelines could result in inconsistent expense documentation and reimbursement. The Commission has examined the audit report's summary of the guideline differences and concludes that the SWB guidelines are less stringent than the MEEG guidelines.

The Commission is convinced that it would be inappropriate and unreasonable under the circumstances to allow SWB to include its entire business meal expense in its cost of service. This type of expense is peculiarly within a utility's ability to control. Ratepayers should not be treated as a deep pocket, burdened by SWB's failure to enforce reasonable controls of its business meal expense. The question then becomes whether it would be appropriate to exclude the entire amount of business meal expense, or whether only a portion of the amount should be excluded.

There is a dearth of evidence in the record which would lend itself to a precise division of allowable and nonallowable business meal expense. As the only other alternative would be to disallow the entire amount, the Commission has calculated an amount which it feels approximates the amount which should be disallowed. The Commission has added the questionable amounts listed in the four audits, and determines that $571,322.44 of the total $1,403,000 sought by SWB should be disallowed, resulting in a net allowance of $831,677.56 for business meal expense. A dollar amount was not listed for every questioned expense in the audit reports, and the Commission's disallowance calculation includes a portion of reimbursements for employee expense account items other than business meals. The Commission is painfully aware that the evidence relied on is not necessarily the best or most accurate evidence which could have been presented. Nevertheless, the Commission has confidence in its calculation, as the four audits merely reflect a certain percentage of expense claimed by certain employees in certain locations for certain periods of time, ranging from two months to a year. Extrapolating from this information and applying it to the total amount of business meal expense claimed, the Commission believes that its calculation manifests a reasonable approximation of disallowable expense.

Additionally, the Commission performed a second calculation based on information provided in two of the four audits. The information includes the number of total documents reviewed, the number of documents with one or more exceptions, and the total number of exceptions. Using these figures, the Commission calculated the percentage of documents with exceptions, and the percentage of total exceptions, for each of these two audits. The Commission's calculations resulted in respective percentages of approximately 39 percent and 54 percent for one audit, and approximately 17 percent and 21 percent for the other audit. An average of the four percentages results in a calculation of approximately 33 percent, which is less than but still within the range of the amount of business meal expense disallowed.

While the existence of an exception does not necessarily mean an expense was inappropriate, it does manifest an inability or unwillingness to enforce SWB's own policies. As an example of the pervasiveness of the lack of enforcement, 39 percent of vouchers submitted by section heads were found to contain one or more exceptions for noncompliance with company practice. If section heads are not following policy, they are less likely to enforce compliance by other employees. Nevertheless, the audit reports appear to indicate that there has been some improvement in the control of business meal expense, although the overall level of improvement is uncertain. It is not the function of the Commission to tell SWB how to run its business; rather, its duty is to set just and reasonable rates. SWB's business meals expense may be reasonable in one sense, yet unreasonable for inclusion in the cost of service which ratepayers must pay.

There are a number of possibilities, however, which SWB could consider in its efforts to control business meal expense, which might encourage Commission confidence in the future. The [illegible] guidelines could be strengthened and made more specific, for example, by better defining what would constitute a lavish or extravagant expenditure. The MEEG guidelines could also be restructured as mandatory regulations rather than as guidelines or goals. Also, the MEEG guidelines could be applied to SWB in lieu of whatever SWB guidelines may currently be in place. SWB could reconsider its policy with respect to advance funding, either delineating and narrowing the circumstances under which this procedure would be available or eliminating the procedure altogether. Another alternative would be to apply a per diem requirement to management as well as nonmanagement employees, perhaps keyed to a geographic index or guide. This would have the advantage of creating uniformity and allowing management employees to know ahead of time what is likely to be considered extravagant. In addition, SWB could consider centralizing its authorization process to encourage uniformity by removing control of the disposition of documents with deviations and documents reflecting special or unusual circumstances from individual managers and placing it with a specific organization such as the Controller Organization. Finally, SWB could develop more uniformity in the performance of internal audit reports so that SWB can make better comparisons and recognize improvements or the lack thereof. The Commission believes that the internal audit reports provide an excellent way for SWB to measure compliance with its own policies and track its progress, and encourages their use. Greater standardization in audit procedures and analysis of results would make the reports more meaningful.

Based upon the evidence presented, the Commission determines that $571,322.44 of SWB's claimed business meal expense should be disallowed.

__FAS 87__

The Financial Accounting Standards Board (FASB) in December 1985 established standards for financial reporting and account of employee pension benefits. The standard is Statement of Accounting Standards No. 87 (FAS 87). Under FAS 87, a company must recognize future pension benefits earned by current

SWB states in its initial brief that "the two issues can be treated individually." The Commission will thus address FAS 106 on its own merits.

The amount of costs associated with the issue appears to include a test year issue. Staff's proposed adjustment is based upon the test year 1991 costs while SWB's cost figure is based upon September 1992 levels. The reconciliation, Exhibit 244, reflects the difference between these two periods rather than a difference for a similar period. The Commission has adopted SWB's position and so will adopt the September 1992 level of costs. These costs appear to have increased significantly and so September 1992 will be more representative of ongoing operations.

<u>FAS 106</u>

The Financial Accounting Standards Board (FASB) adopted Statement of Accounting Standards No. 106 (FAS 106) in December 1990. FAS 106 changed the way companies would account for postretirement benefits other than pensions on their financial books. These postretirement benefits, for SWB, include health benefits, dental benefits, basic life insurance benefits and telephone concessions. These benefits have been commonly referred to as OPEBs (other post-retirement employee benefits) by those dealing with the subject.

FAS 106 was adopted January 1, 1993 for SWB's financial books. The adoption of FAS 106 changed the accounting procedure for OPEBs from a pay-as-you-go (cash) basis to an accrual basis. This change substantially increased SWB's OPEB expenses. FASB's stated purpose in adopting accrual accounting for OPEBs is that OPEBs are seen as a deferred compensation arrangement for which the costs should be accrued when incurred rather than when paid out. This matches the costs accrued to the time period in which the benefits are earned during the working years of the employee. FAS 106 has been required for regulated utilities.

Under FAS 106, future costs of OPEBs must be estimated so that their present value can be included as a current expense. The current expense includes calculation of an expected postretirement benefit obligation (EPBO), calculation of an accumulated postretirement benefit obligation (APBO) and service cost, and a calculation of net periodic postretirement benefit costs. The EPBO is a valuation of all future benefits expected to be paid on behalf of current active and retired employees. The APBO represents the portion of the EPBO attributable to employee service prior to the current fiscal year. The service cost is the portion of the EPBO attributable to the current fiscal year. The net periodic postretirement benefit cost is the sum of the service cost, interest cost, return on plan assets, recognition of transition benefit obligation (TBO), and recognition of gains or losses and effect of past amendments. The Missouri jurisdiction's portion of TBO is $332.8 million.

SWB proposes that the Commission adopt FAS 106 for ratemaking purposes. and establish safeguards which the Commission determines are appropriate. This action, SWB contends, will protect it from financial harm and assure the Commission that ratepayers are also protected.

SWB asserts generally that FAS 106 should be adopted because (1) the telecommunications industry is very different from the energy utility industry (the Commission had denied FAS 106 ratemaking treatment for two energy utilities at the time of the hearing), (2) the Commission should be consistent with FAS 87, (3) SWB needs FAS 106 to meet competition, (4) FAS 106 can be adopted without a rate increase, (5) its efforts to contain costs should be a factor in adopting FAS 106, (6) its commitment to fully fund its FAS 106 obligation should be a factor, (7) accrual accounting provides intergenerational matching and is more appropriate ratemaking, (8) its actuarial studies are good, and (9) failure to adopt FAS 106 will harm SWB's financial conditions. GTE supports SWB's position on FAS 106.

employees as current pension costs rather than when the pension benefits are actually paid. Pension costs are made up of service cost, interest, return on plan assets, prior service cost and amortization of gains and losses, and amortization of the transition asset or liability. Upon initiation, SWB's plan assets exceeded its liability, so SWB had a transition asset. This amortization, over 18 years, reduces the current pension costs. From 1988 through 1992 SWB made no contribution to its pension fund because the fund was self-supporting.

FAS 87 was adopted for ratemaking purposes for SWB in TC-89-14. 29 Mo. P.S.C. (N.S.) at 618. The Commission in that case generally adopted Part 32 for ratemaking purposes and specifically mentioned the acceptance of FAS 87. Adoption of FAS 87 in TC-89-14 reduced SWB's cost of service.

SWB supports the retention of FAS 87 procedures for ratemaking purposes in this case. SWB points out that determination of sharing under the experimental incentive plan used FAS 87 accounting for pension costs. SWB also argues that FAS 87 recognizes that an employee earns pension benefits over the employee's service life and that SWB should recognize the cost of providing pension benefits during that same period. SWB also points out that the determination of these costs is performed by actuaries using one standard method of calculation.

Commission Staff has proposed that pension fund expenses should be calculated using the minimum filing requirement of the Employee Retirement Income Security Act (ERISA). These funding requirements, Staff states, have been established by the federal government to ensure pension plans are adequately funded to meet the obligations of the plans. Internal Revenue Service regulations allow a tax deduction for contributions up to a maximum contribution. Staff asserts that following ERISA minimum contributions requirements ensures SWB's pension plan is adequately funded and ratepayers are thus paying a reasonable level of expenses for this item.

Staff points out also that SWB's current plan is overfunded because SWB has made no contributions to its pension fund between 1988 and 1992. This means that SWB's fund is earning an amount over the current projected benefit obligation (PBO) and the PBO which will result from estimated wage and salary increases to occur between now and retirement for its current employees.

The actuarial difference between FAS 87 pension expense and the ERISA minimum contribution in a given year is in the method used to calculate the expense. Over time, both methods will provide sufficient funds to ensure SWB can pay its pension plan obligations. Both methods recognize the total pension obligation. The Commission is faced, then, with determining which accrual method is the more appropriate for ratemaking purposes.

Even though Staff has raised several issues concerning use of FAS 87 which the Commission has found persuasive in other cases, the Commission finds, for SWB, that continued use of FAS 87 for pension expense is the more reasonable approach. The distinction here is that the Commission has already approved FAS 87 for SWB and to alter that method without some compelling change in circumstances would be arbitrary. Staff conceded this issue in TC-89-14 and even though SWB's FAS 87 funding still exceeds its PBO, that is no justification for changing accounting methods. In addition, there is the possibility that changing from FAS 87 to ERISA would cause SWB to write off an accumulated prepaid asset balance. Staff questions whether this write-off should occur for all pension credits recorded on SWB's books since 1988, but Staff recognizes that some write-off may occur. The Commission finds that the change to FAS 87 was found to be reasonable in TC-89-14 and that another change, with a potential write-off, is unwarranted. Both methods proposed achieve the same result, so it is more reasonable to continue with the method approved in TC-89-14. The continuation of FAS 87 does not, then, resolve the FAS 106 issue to be addressed next. Even

Commission Staff opposes adoption of FAS 106 for ratemaking purposes and supports continuation of pay-as-you-go. Staff argues, basically, that FAS 106 is not appropriate for ratemaking because SWB has no long term legal obligation to pay any determinate level of benefits, and the accrual technique uses data that is difficult to estimate and small variations in data cause dramatic changes in expense calculations. OPC also opposes the adoption of FAS 106 for ratemaking.

The Commission has addressed the issue of whether to adopt FAS 106 for ratemaking purposes in several recent cases. These cases are:

Case No. EO-92-179	-- Union Electric Co.
Case No. EO-93-35	-- The Empire District Electric Co.
Case No. GO-93-201	-- Western Resources, Inc.
Case No. ER-93-37	-- Missouri Public Service
Case No. ER-93-41	-- St. Joseph Light & Power Co.
Case No. TR-93-181	-- United Telephone Co. of Missouri
Case No. WR-93-212	-- Missouri-American Water Co.

The two most recent cases involved Missouri-American Water Company and United Telephone Company of Missouri. In these two cases the Commission cites its responsibility to balance the requirements of ratepayers and shareholders to ensure that rates are just and reasonable and to ensure that safe and adequate service is provided. In both of these cases the Commission found that adoption of FAS 106 was not supported by the evidence. The main two reasons for the Commission's finding were that (1) the actuarial studies were too speculative and (2) eminent federal legislation concerning a national health care plan made any decision to adopt FAS 106 premature.

In this case SWB has presented the Commission with additional proposals concerning FAS 106 that would ameliorate the effects of the change to accrual accounting if FAS 106 were adopted. The evidence shows that SWB has an aggressive cost containment program to limit its exposure to escalating health care costs. SWB has implemented a custom care managed network system as well as placed an expense cap on retiree benefits. These actions make SWB's future expenses less speculative.

In addition to cost savings, SWB has funded approximately 80 percent of its annual OPEB liability through a transfer from its pension fund to a VEBA trust. The VEBA trust only applies to collective bargaining employees, but SWB's evidence indicates that it may legally fully fund its VEBA trust and cover its management employees' OPEBs until nonmanagement employees' OPEBs costs reach the fully funded amount.

The Commission finds that SWB's attempts to control costs and bring more certainty to OPEB costs, as well as the provisions for the VEBA trust and commitment to fully fund this trust, are the types of requirements that the Commission would impose if FAS 106 were adopted. The Commission, though, finds that these procedures do not outweigh the fundamental problems the Commission must resolve before adopting FAS 106 for ratemaking.

The Commission first must be convinced by the evidence that the actuarial studies of OPEBs are sufficiently exacting to render a reasonable estimate of future costs even with the cost-reducing measures. Once put into rates, the OPEB costs will remain there until either a general rate case or complaint case is filed and a full audit of SWB's cost of service can be completed. Until that time ratepayers would be paying for OPEB costs as calculated in this case.

The Commission finds that the significant increase in costs for OPEBs is not justified based upon the speculative nature of the actuarial studies. The Commission does not fault the actuaries but finds that projecting health care costs out thirty years or more in today's environment is pure guesswork. The effects of the single most important factor in the future costs of OPEBs, a national health care plan, could not have been realistically analyzed when SWB's studies were performed.

Other factors, of course, are what benefits will be provided by SWB in the future, what technological advances will occur, what industry changes will occur, what other government regulations will be promulgated and what the inflation rate will be, to name a few. Projecting the changes that will occur with regard to these factors is too uncertain to convince the Commission that it is reasonable to adopt FAS 106. Perhaps if a national health care plan is adopted, the costs associated with OPEBs will be more amenable to estimation.

The Commission, by not adopting FAS 106 for ratemaking, recognizes that it is treating these costs differently from FAS 87 costs. Even with the similarities, SWB has stated that different treatment is acceptable. In addition, SWB has a legal obligation to fund pension costs, while the only limitation on SWB changing the benefit level of OPEBs is the five-year prohibition against reducing benefits when a VEBA trust is funded. SWB indicates in its employee information that it reserves the right to end or amend any or all of the OPEB plans. While this may be limited by collective bargaining for current nonmanagement employees, it would not necessarily apply to retirees or to management employees.

SWB has argued that it is subject to substantial competition and since FAS 106 is required for nonregulated businesses it should be allowed for SWB. The Commission finds that the competition argument cuts both ways. Since most nonregulated companies have written off FAS 106 TBO costs in 1993, as SBC did; then, as a substitute for competition, the Commission could reasonably require the write-off by SWB of the TBO if it approved FAS 106. SWB, of course, contends this would not be proper. The Commission at this time need not decide how to treat the TBO since the Commission has found that FAS 106 should not be adopted for ratemaking.

SWB also argues for FAS 106 adoption based upon the intergenerational equity argument. The theory behind FAS 106 and accrual accounting is that costs should be recovered when benefits are earned. Thus, current ratepayers should pay for current employees' future OPEB costs. This is reasonable except for the TBO, which requires current and future ratepayers to pay for OPEB costs accrued during a past period. This creates intergenerational inequity for current and future ratepayers.

The Commission recognizes that a substantial majority of other state commissions and the Federal Communications Commission and Federal Energy Regulatory Commission (FERC) have addressed these issues and found that FAS 106 should be adopted for ratemaking. The Commission, though, believes that, even with the safeguards required by many of the states, recognition of FAS 106 is premature. If a national health care plan is adopted, these commissions will face difficult decisions on how to reflect the plan for ratemaking purposes. The Commission is also concerned about the possibility that the TBO violates the prohibition against retroactive ratemaking.

The Commission also believes that its treatment of FAS 87 does not resolve the retroactive ratemaking issue. No party raised the issue of retroactive ratemaking in TC-89-14 when SWB was proposing adoption of FAS 87. Since FAS 87 created a transition asset, the Commission was not presented with the issue, so the FAS 87 decision provides no guidance.

Additionally, the Commission does not believe the fact that this issue arises in a rate reduction case should be considered significant. FAS 106 costs, including the TBO, are so substantial that they will significantly affect results of this case and any sharing plan that might be adopted. To set rates at a just and reasonable level, the Commission finds it must address FAS 106 on its own merits and not the type of case in which it is raised. The evidence does not support adoption of FAS 106 for ratemaking purposes

In addition, a subissue presented by SWB witness Toti proposed that FAS 106 be adopted for determining credits for 1993 under the experimental incentive regulation plan. The Commission finds that, based upon its decision in this case, that would not be appropriate.

FAS 112

The last of the FASB statements concerning employee benefits is FAS 112. This statement is entitled "Employers Accounting For Postretirement Benefits". This statement adopts accrual accounting for employers who provide benefits to former or inactive employees after employment but before retirement. These costs are related to employees receiving long term disability leave, severance payments and supplemental unemployment benefits.

The evidence indicates that FAS 112 and pay-as-you-go cause similar costs so no change has been proposed for FAS 112. The transition amount, SWB has proposed to amortize over three years. The amounts in issue in this case relate to the TBO. Staff opposes the inclusion of the FAS 112 TBO in this case since SWB has decided to incur the cost early, almost twelve months before FASB requires adoption. Also, SWB's early adoption of FAS 112, Staff states, is outside of the test year and update period.

In its reply brief, SWB points out that Staff's position in its testimony is that FAS 112 costs should be dealt with in the sharing under the experimental incentive regulation plan in Case No. TO-90-1. The Commission finds that this is the appropriate treatment of the FAS 112 TBO. Thus, there will be no revenue requirement adjustment for the FAS 112 TBO in this case.

Rate of Return

A. Return on Equity

The overall rate of return (ROR) is established based upon cost of debt and return on equity (ROE) as weighted using what is found to be a reasonable capital structure. Where a company has stock which is publicly traded, the

Commission normally utilizes the company's actual debt cost and capital structure in calculating the overall ROR, and the Commission has traditionally used the discounted cash flow (DCF) method to calculate a reasonable ROE.

Since SWB is not publicly traded and its stock is held 100 percent by its parent corporation, Southwestern Bell Corporation (SBC), the ROE must be calculated on some other basis. The parties in this case have proposed using different capital structures and cost of debt than SWB's actual capital structure and cost of debt. As a point of reference, the Commission found in SWB's last complaint case, TC-89-14, that SBC was an appropriate proxy for SWB, and that the results of a DCF analysis for SBC should be used as the ROE for SWB, and that SBC's capital structure and cost of debt should be used to calculate the overall debt for SWB.

This case presents the Commission with similar issues concerning the appropriate ROE, cost of debt and capital structure to use in establishing a reasonable overall ROR for SWB. Three parties presented evidence on these issues, SWB, Staff and OPC. The different methods resulted in the following proposals.

	Staff	OPC	SWB
ROE	10.21% to 11.21%	10.5 %	14.1 %
Cost of Debt	7.33%	7.44%	7.66%
Capital Structure:			
Debt	44.35%	50.00%	42.58%
Equity	55.65%	50.00%	57.42%
Overall ROR	8.93% to 9.49%	8.97%	11.36%

Staff utilized two methods to arrive at what it considered a reasonable ROE for SWB. First, Staff witness Moore calculated an ROE for SBC using the constant growth DCF model. This approach resulted in a range of ROE for SBC of 10.62 percent to 11.72 percent. Staff witness Johnson then adjusted the SBC ROE based upon his analysis of the reduced risk SWB encounters in its operations as compared to those of SBC. This adjustment was 51 basis points to arrive at a recommended ROE for SWB of 10.21 percent to 11.21 percent.

SWB utilized various risk premium methods and a capital asset pricing model (CAPM) method as well as proposing a recalculation of Staff's DCF. SWB witness Avera presented these analyses and the resulting ROEs were from 11.62 percent to 14.98 percent. SWB, though, proposes that the Commission approve an incentive regulation plan for SWB and that it retain the 14.1 percent ROE reflected in the current experimental plan as the level where sharing begins.

OPC developed an ROE based upon a DCF analysis of Regional Bell Operating Company (RBOCs) and a group of nine natural gas companies. OPC witness Hill also calculated a capital asset pricing model (CAPM) to test the reasonableness of the DCF analysis. Based upon his analysis, Hill recommended an ROE of 10.5 percent.

The Commission's obligation in establishing an ROE for a regulated company is to set a return which provides a reasonable return on investment of the company with a focus on establishing a return commensurate with those companies with similar risks. Although the Commission determines a reasonable ROE, it does not guarantee a certain return.

The Commission has considered the various methods proposed by financial analysts in other cases and has found that the constant growth DCF method consistently provides an ROE that is reasonable and reflects the conditions faced by a regulated entity. The DCF is a market-oriented approach which relies upon the fact that a company's common stock price is dependent upon the expected cash dividends and upon cash flows received through capital gains or losses that result from stock price changes. The DCF formula calculates its ROE using the following formula:

$$K = \frac{D_1}{Po} + g$$

K represents the cost of common equity, D_1/Po is the expected dividend yield, and g is the growth in dividends continuously summed to the future. The growth in dividends and implied growth in earnings will be reflected in the current price. The DCF model then recognizes the potential for gains or losses associated with owning a share of SWB's common stock.

From a review of the methods used by the parties to calculate a reasonable ROE for SWB, the Commission finds that Staff's DCF calculations based upon SBC operations best reflect the conditions affecting SWB and best establish the basis for a reasonable ROE for SWB. Staff's range of reasonable ROEs allows the Commission the flexibility to arrive at a reasonable result for SWB.

Staff's growth values are based upon SBC's actual earnings per share and dividend per share from 1984 through 1991. By taking the higher dividend growth rate for its DCF calculations, Staff reflected SBC's historical dividend growth rate, which can reasonably be expected to continue into the future. This historical growth rate established the lower end of Staff's range for g in the DCF formula.

Staff then took projected earnings growth rates and dividend growth rates for SBC as calculated by various leading economic forecasters. Since the projections varied, Staff's use of an average of these projections properly reflects the general projected trend. The historical growth of SBC at 6.15 percent and the projected growth of 7.25 percent established a reasonable range of growth for the DCF calculation.

Staff's DCF calculation uses the projected dividend of $3.00 per share and took an average market price of SBC stock for the period September 1, 1992, through December 31, 1992. This gave an expected dividend yield of 4.47 percent. Since the yield figure is based upon stock prices over a four-month period of 1992, it captures what should be SBC's stock prices into the future. Putting Staff's yield and growth range into the DCF formula results in the range of ROE for SBC of 10.62 percent to 11.72 percent.

The Commission finds that Staff's range is reasonable based upon current economic conditions. There is no question that interest rates have fallen since 1989 when the Commission found the reasonable ROE to be 12.61 percent. Long term interest rates have fallen 100 basis points. Projections are that long term rates will go up in the future. Whether they will return to 1989 levels or beyond is speculative. The high end of Staff's range allows for some movement of long term interest above current rates.

The Commission finds that, as in 1989, SWB dominates SBC's profitability to such an extent that SBC is the best proxy for determining a reasonable ROE for SWB. SWB in 1991 was responsible for 80 percent of SBC's revenues, also 80 percent of SBC's consolidated net income and 76 percent of SBC's consolidated total assets. Investors buy shares of SBC realizing that SWB is such a significant portion of SBC's operations.

The Commission also finds that use of SBC's ROE for SWB allows for the increased risk SBC's consolidated operations have over SWB's regulated operations. By using SBC as a proxy, the Commission recognizes what SWB claims is its increased risk of competition and that risk is reflected in the DCF calculation of the ROE of SWB proxy SBC.

Since the Commission has found that SBC is an appropriate proxy for SWB in determining an ROE, the Commission will not make the 51 basis point adjustment to SBC's ROE for the reduced risk found by Staff witness Johnson. The Commission agrees with Johnson that SWB is less risky at this point than SBC, but because of competitive pressures and the uncertainties involved in changes in the telecommunications industry, the Commission finds the adjustment would not be reasonable. By using SBC as a proxy, the Commission has accounted for the risks SWB believes it will face in the near future.

By adopting the DCF method for use in this case and SBC as a proxy for SWB, the Commission finds what it believes is the most reasonable approach to calculating an ROE for SWB. Risk premium analyses such as those proposed by SWB and use of DCFs by groups of other companies do not produce results which are as reasonable. Although risk premiums may, as the Commission has said, be based upon an appropriate theory, they are not subject to any reasonable calculation. The range of SWB's analyses is from 11.62 percent to 14.98 percent. The methods used by SWB manipulate the data in various ways, all to find that ethereal quantity: what risk does an investor expect to be compensated for when investing. SWB's risk premium attempts to find this risk premium for SWB rather than SBC, thus adding an additional element of conjecture since SWB is not publicly traded.

Four of the five of SWB's risk premium analyses indicate that investors find that potential investors of SWB would find its stock, if publicly traded, to be riskier and therefore expect a higher return than what Staff's DCF model indicates for SBC. This, the Commission believes, does not comport with reality and belies the use of risk premium analyses for regulated utilities whose stocks are not publicly traded.

The Commission believes that investors of regulated telecommunications utility stocks see these high dividend yield companies as alternatives to money market funds and certificates of deposit. Regulated utilities provide a safe, low-risk investment with a good level of income especially when interest rates are low. Maybe as SBC's profitability begins to reflect the shift to unregulated activities, higher ROEs may be expected for SBC and it will no longer be an appropriate proxy for SWB. This is not the case now. The Commission also does not believe it is reasonable to adopt methods that show SWB riskier than SBC.

In addition, SWB proposes that the Commission take the high end of those risk premium results at 14.1 percent. This is completely contrary to the changed circumstances in the economic markets, and also, the 14.1 percent was a negotiated value based upon where sharing would start in the incentive regulation plan. There is no support in any record for this figure, nor does the 14.1 percent reflect where sharing should start under a current plan. SWB's proposal would require the Commission to suspend its statutory responsibility and also its judgment in this matter.

The Commission also cannot adopt OPC's analyses. As stated earlier, SBC is a better proxy for SWB than groups of other regulated companies, whether telecommunications or gas. In addition, rather substantial questions have been raised regarding the relationship of beta used in the CAPM analysis and return for regulated utilities. Where a proxy such as SBC is available, the Commission finds it is more reasonable to use that proxy than to attempt to arrive at a decision of what companies compare with SWB in both risk and operations.

The Commission finds that the high end of Staff's range for SBC using the DCF formula, 11.72 percent, is the most appropriate ROE for SWB. The Commission will not adjust this rate for flotation costs since SWB does not propose to issue stock in the near future and there are no stock issuances in the test year.

B. Cost of Debt and Capital Structure

Even though the Commission finds that SBC is an appropriate proxy for SWB for determining a reasonable ROE, the Commission finds that SWB's actual cost of debt and capital structure should be used in calculating SWB's actual ROR. The Commission finds that use of either SBC's cost of debt and capital structure or a hypothetical capital structure would prevent SWB from recovering its actual debt costs, and there is no basis for developing a hypothetical capital structure for SWB since its equity to debt ratio is reasonable. Hypothetical capital structures should be used only when a company's actual capital structure does not reflect a reasonable ratio of debt to equity.

Based upon the decisions on ROE, cost of debt and capital structure, the overall ROR for SWB found to be reasonable is 9.99 percent.

Rate Design

A. Stipulation

Several parties presented a stipulation concerning the SWB services which should be reduced if the Commission found that SWB is overearning. These reductions were a settlement of most of the issues regarding rate design raised by the parties in their prefiled testimony. The stipulation, Exhibit 159, establishes incremental reduction in various services depending upon the total amount of reduction ordered by the Commission. Six issues were left unresolved by the stipulation: (1) changes to Lifeline rates, (2) payment of access charges by cellular carriers, (3) appropriate criteria for the ability to make use of call trace service, (4) appropriate treatment of private pay phone providers, (4) direct inward dial trunk rate, and (6) opposition to a reduction in message toll rates.

The Commission has reviewed the stipulation and will adopt the incremental reductions except for those assigned to SWB's Lifeline rate. In addition, any adjustments to rates based upon the resolution of the unresolved rate design issues will reduce or increase the incremental amounts assigned to Touchtone service.

Additionally, the Commission believes that Touchtone rates should be the same for businesses as well as residence customers. Creating one rate for Touchtone will reduce the cost of this service for business customers. The Commission believes that Touchtone is becoming, if it has not already become, a necessary part of basic service and should be priced at the same cost for all customers. The evidence indicates that SWB customers perceive Touchtone as a part of basic service, not a luxury. The residential Touchtone penetration is 77.92 percent and business penetration is 92.1 percent as of December 1992. The reduction in Touchtone rates which results from the rate reduction in this case should be reflected in one rate for Touchtone service for all customers.

MCTA proposes that basic local rates be the first to be reduced rather than the last as reflected in the Stipulation. The reduction of basic local rates, MCTA asserts, would make the state of Missouri more attractive to businesses.

The Commission finds that the Stipulation establishes a reasonable priority for reducing rates. The reduction of access and MTS rates will benefit business customers and residential customers, as well as the reduction in Touchtone rates. The reduction of these access and MTS rates will also address SWB's concerns about competition, especially since the reduction is substantially larger than that proposed by SWB in its alternative regulation plan.

B. Lifeline Rates

SWB has proposed, as part of its alternative regulation plan, changes in its Lifeline program. These changes would increase availability and increase the costs of the program. This proposal was adopted as part of the stipulation on rate design. Midwest Independent Coin Payphone Association (MICPA) opposes the Lifeline proposal. MICPA's opposition rests on two basic premises. First, MICPA argues that Lifeline rates were created by the legislature and only the statutes can define who are eligible subscribers. MICPA points out that since the creation of Lifeline is statutory, it is an exception to the prohibition against discrimination in Section 392.200, R.S.Mo. (Supp. 1992). Second, MICPA points out that the costs of SWB's Lifeline proposal are unacceptable. With approximately 100,000 customers eligible under the new proposal, as opposed to

13,952 with the current program, the costs would increase between about $5 million and $11 million rather than the $2 million estimated by SWB.

The Intervenors for Independent Options support the expansion of the Lifeline program to include additional low income customers. This expanded program, these intervenors assert, will be a much more wisely targeted plan than the current program.

The Commission finds that SWB's Lifeline proposal should not be adopted since it would establish a separate rate for basic telephone service in violation of Section 392.200, R.S.Mo. The rate would be discriminatory since SWB's classification for the service has no clear distinction from basic local residential service. The current Lifeline rates are statutorily mandated and have clear criteria for eligibility. In addition, this program would create a different standard in SWB's service territory as compared to programs in other telephone company service areas.

Although additional funding of the Lifeline program would be in the public interest and would aid those older residents who are on fixed incomes, the Commission finds that SWB's proposal is too loosely structured and too costly. In addition, this is a legislative program which should be addressed by the General Assembly so that all Missouri residents are treated similarly.

C. Call Trace

SWB offers a Call Trace service to customers who are receiving offensive or unwanted telephone calls. This service provides that SWB will trace incoming calls designated by the customer and will forward these numbers, upon request, to the proper authorities. Under current tariffs a customer must subscribe to electronic Call Trace service and must pay a service establishment charge and a service and equipment charge upon subscription. Once the customer subscribes, the customer must then pay for each activation of a trace. The charges are:

	Residential	Business
Service Establishment Charge	$2.00	$ 2.00
Service and Equipment Charges	7.75	14.50
Activation Charge	8.00	8.00

The evidence also indicates that SWB will manually trace a call at no charge to a customer for nuisance and unwanted calls if the customer notifies SWB. Under this procedure, the customer is contacted by SWB employees and must document offending calls. This process is more cumbersome than the electronic Call Trace service, which is performed by the switch and so is simpler and more efficient. The customer activates the trace by dialing three digits.

OPC proposes that the Commission reduce the rates for Call Trace service. OPC contends that the current rates are to deter customers from taking the service so that a customer will subscribe to Caller ID service, which provides the customer with the telephone number of the caller. OPC believes that Call Trace is more effective and less intrusive than Caller ID service.

OPC proposes that SWB should not charge a service establishment charge or service and equipment charge for Call Trace. OPC proposes that, as with calls to SWB to trace nuisance and unwanted calls, Call Trace service should be free, with only a $1.00 activation charge and a $7.00 follow-up charge. OPC suggests that these rates are above SWB's incremental costs for the service.

SWB states in its reply brief that OPC's proposal in its initial brief is substantially different from the proposal in OPC witness Thompson's testimony. SWB points out that Thompson proposed only a $1.00 activation charge in his testimony. SWB also argues that OPC is using this issue to continue its opposition to Caller ID.

The Commission finds that Call Trace service should continue to be priced as it is. The rates will ensure that tracing of calls and forwarding of caller telephone numbers to police will only occur under proper circumstances. Caller ID service can be used by those persons who just wish to monitor their incoming calls. Call Trace service should be for those customers who may need police intervention. The Commission also agrees with SWB that OPC seems to be continuing its struggle against Caller ID through an attack on Call Trace service.

D. Cellular Interconnection Service

OPC proposes in this case that the Commission require SWB to charge originating switched access to cellular carriers for traffic that is transported across the local calling area's boundary by the cellular carrier. OPC points out that this call would be from a land line to cellular interexchange call.

CyberTel Cellular Corporation (CyberTel), McCaw Cellular Communications, Inc., and ALLTEL Mobile Communications of Missouri, Inc., intervened in this case for this limited issue and oppose OPC's proposal. SWB also opposes OPC's proposal.

This issue is an attempt by OPC to have the Commission revisit two decisions from very long and complicated proceedings involving SWB's rate to be charged cellular carriers. Cases No. TC-86-158 and TR-90-144 addressed SWB's cellular interconnection tariff and established how cellular carriers would be charged. OPC, as in the Call Trace issue, seems to be burdening an already extremely long record with issues unrelated to SWB's revenue requirement or how to distribute any reduction. In addition, OPC seems to be revisiting an issue here that has been extensively addressed in two separate dockets. OPC may not like the Commission's decision in those cases, but raising these tangential issues in this case does not appear to be productive. Given that it has been raised, though, the Commission will address OPC's proposal.

The Commission, after a review of OPC's evidence, is not convinced that charging originating switched access to cellular carriers for traffic transported across the local calling area boundary by the cellular carriers is workable or reasonable. The problem of self-reporting is sufficient evidence that OPC's proposal should not be adopted. Cellular areas that overlap various land line calling scopes make any reporting uncertain, while self-reporting itself would seem to be of questionable accuracy.

In addition, the cellular companies indicate that the change proposed by OPC could affect the charges which are assessed for other calls. Other questions are raised about the effect of any change and whether interexchange carrier toll calls are as similar to cellular carrier calls as OPC asserts. These questions should be addressed, as they were previously, in a separate docket where the issues can be fully developed. The Commission finds there is insufficient evidence to change SWB's cellular interconnect charges in this case.

E. Direct Inward Dial Trunk Rate

This issue was raised by the Department of Defense and Federal Executive Agencies (DOD). DOD witness Gildea suggested in his testimony that if rates were found to be excessive, a high priority should be given to rate reduction for Direct Inward Dial (DID) trunk rates. As SWB points out, there is no evidence in the record upon which to make a determination that a reduction is appropriate. The Commission finds that it cannot decide that a reduction to DID rates without any evidentiary support.

F. Message Toll Service Reduction

The stipulation provides that Message Toll Service (MTS) rates would be assigned a significant portion of the reduction ordered by the Commission in this case. MICPA opposes this proposed assignment because SWB's MTS has been classified as transitionally competitive (TC) and is therefore available for pricing flexibility, and that SWB will recoup some of the rate reduction through usage stimulation of MTS. MICPA proposes that the amounts assigned in the stipulation to MTS rates be spread among noncompetitive services such as local business rates, which MICPA contends are priced too high in relationship to local residence rates and trunk lines.

The Commission recognizes the potential for pricing flexibility of MTS since it has been classified as TC. The Commission questioned Staff witness Goldammer and SWB witness Robertson about this issue and neither expressed concern. SWB has not filed for a rate band for MTS service. When it does, the Commission will be faced with the question of the reasonableness of the maximum and minimum rates of the band. The Commission believes that the case addressing the rate band for MTS is the more appropriate place to address MICPA's concerns.

Usage stimulation is always a possibility when rates are reduced. This result, though, is no reason not to reduce rates. If customers utilize the service more when rates are reduced, they are receiving the benefit of the reduction and any increased revenues to SWB flow from that benefit. No rates would be reduced if the Commission's goal was to limit stimulation, and therefore SWB's increased revenues, from any stimulation. Neither of MICPA's arguments are sufficient to eliminate a reduction in MTS rates as proposed. MTS rates are paid by the very business customers who would benefit from MICPA's proposal to reduce single line business rates. A reduction in MTS rates might even be more beneficial to these customers. Recognizing this fact, the Commission will not eliminate the MTS rate reduction from the assignment proposed in the stipulation.

G. Private Pay Phone Interconnection Rate

At the divestiture of SWB from AT&T, private pay phones became a market in which companies could compete with SWB. The General Assembly gave the Commission limited jurisdiction over private pay phone companies in 1987. Section 392.570, R.S.Mo. (Supp. 1992). Private pay phone services are described as "customer owned coin telephone services" in the statute. The statute gives the Commission authority to establish rates or charges and terms of connection for access of private pay phones to the local exchange network.

Competition between private pay phone providers and SWB has increased significantly over the years, bringing about technological changes to pay phone equipment. Some pay phones now contain a small computer station which can be programmed to provide teleconferencing, message forwarding, advanced emergency services and credit card acceptance.

MICPA, the Midwest Independent Coin Payphone Association, has proposed to change the rates charged by SWB for interconnection of private pay phones to SWB's network. Under current tariffs, private pay phone providers pay a monthly charge of $30.70 plus usage-sensitive charges which vary with time and distance. MICPA proposes to eliminate the usage-sensitive charge and change the monthly charge to the current rates for the one party business service. SWB opposes the change in rates, as does Staff. Staff recommends the issue of rates and other private pay phone service matters be addressed in a generic docket.

Although MICPA raises several additional concerns about private pay phone operations, the main focus of its position is on the similarity between it and similar resellers of telecommunications service such as Shared Tenant Services (STS) and hotel/motels. These resellers are charged a flat rate of access. MICPA argues the one party business service is indistinguishable from service provided to private pay phone service except for selective class of call screening, which is a separate service.

The evidence in this case reveals that SWB's flat rate of $30.70 covers SWB's incremental cost of providing service to private pay phone providers and provides a sizeable contribution to common costs. The evidence also indicates that the usage-sensitive charges do not provide a price signal to the end user since the Commission has capped pay phone charges at $.25. The $.25 is for a call of any length. Under these circumstances the only purpose of usage-sensitive rates would be to recover costs which, the evidence shows, are being recovered through the flat rate.

Based upon the existing $.25 cap and the fact that SWB's incremental costs are covered by the monthly flat rate, the Commission finds that elimination of the usage-sensitive charge for private pay phone service is reasonable. The Commission finds, additionally, that private pay phone service is distinguishable from that of other resellers such as interexchange carriers (IXCs) because of the $.25 cap, and therefore other IXCs would not be a position to seek flat rates for access.

By eliminating the usage-sensitive charges, the Commission is also reflecting the similarity between private pay phone providers and STS providers. Both are covered by Section 392.520, R.S.Mo. (Supp. 1992), and are subject to minimum regulation. The Commission finds that these rates should be structured in a similar manner as long as they cover incremental costs, as they do here.

The Commission finds that the one party business cost is not appropriate for private pay phone service. Pay phones are a distinct type of service and although generally similar to business use, they are not the same. Private pay phone providers are resellers of telecommunications service and as such should be charged rates which reflect that different use of the network. The Commission finds that the $30.70 monthly charge is a reasonable rate for private pay phone service and should be continued.

The Commission is of the opinion that a generic docket would not be beneficial at this time. Rates for private pay phone providers have been addressed in this case and in Case No. TR-93-181 for United Telephone Company of Missouri. SWB has agreed to recommend a solution to price and/or calling scope issues for pay phones in Case No. TO-92-306 by December 31, 1992. The Commission's decision in this case may resolve the price issue. SWB has proposed to change the calling scope of its public pay phones located in Tiers 3 and 4 of the Wide Area Service Plan in Kansas City and St. Louis. This proposal seems out of place and any calling scope recommendation should be made in Case No. TO-92-306 and should reflect the implementation of Metropolitan Calling Area service. The Commission will not approve SWB's proposal in this case.

__Summary of Ratemaking Issues__

The Commission has received into the record as Exhibit 247 the scenarios and scenario responses, which reflect the dollar amounts associated with the Commission's revenue requirement decision in this case and the rate reductions for the rate design decisions. The results of the scenario indicate that SWB is overearning in the amount of $84,617,000. The response to the rate design scenario reflects the reductions in rates which are required to achieve the reduction in SWB's earnings. The Commission finds that by reducing SWB's rates as found appropriate, that SWB will be earning at a reasonable level based upon the decisions in this case. The reasonable level of earnings results after the reduction of revenues in the amount of $84,617,000.

__Incentive Regulation__

The issue of an alternative form of regulation for SWB originated in the reports filed by SWB, Staff and OPC in Case No. TO-90-1. These reports were filed pursuant to an agreement adopting what has been termed the "revised experimental incentive regulation plan". The experimental plan was established for a three-year period and has been extended until January 1, 1994, to allow consideration of a future alternative regulation plan. The reports discussed the perceived successes or failures of the experimental plan and offered proposals for the development of a future plan. Case No. TO-93-192 was established to address a future plan and Staff's complaint case, TC-93-224, was consolidated with TO-93-192 since many of the issues and positions of the parties in the two cases overlapped. The proposals sometimes refer to the plans as incentive plans. For the Commission's purposes, the proposals will be viewed as proposals for alternative regulation, and thus the focus is shifted to the reasonableness of an alternative form of regulation rather than the need for incentives and what these incentives are.

Although OPC, Staff and SWB agree that an alternative regulation plan would be acceptable to them, they differ over the structure of such a plan. SWB proposed that an alternative regulation plan should be adopted rather than determining if SWB is overearning as alleged by Staff. The Commission, though, as stated in the first part of this Report And Order, finds that it could not fulfill its statutory responsibility by just adopting a plan based upon SWB's parameters without first reviewing Staff's allegations to determine what a reasonable revenue requirement for SWB is and, based upon that revenue requirement, establishing just and reasonable rates for the telecommunications services offered by SWB. The Commission in the preceding section of this Report And Order has found that SWB is overearning by $84,617,000 and has established a reasonable revenue requirement for SWB. Even though the Commission has not adopted SWB's plan and has instead considered Staff's complaint, the Commission believes it is necessary to address SWB's plan and other proposals for alternative regulation.

A. SWB's Proposal

SWB proposes that the Commission maintain the general outline of the revised experimental incentive regulation plan and make it a permanent plan under which SWB would operate for at least three years, but with no automatic requirement for an end to the plan. SWB proposes that the sharing grid under the experimental plan be continued, if yellow pages imputation is adopted, or the sharing level would be adjusted 340 basis points downward if yellow pages imputation is not adopted. As is discussed under the yellow pages issue, SWB proposes that yellow pages not be imputed in this or the complaint case. SWB's proposed sharing grid with yellow pages is set out below:

EARNINGS LEVEL	SHARING PERCENTAGE	
	SWB	Customer
Up to 10.7% ROE	100%	0%
Over 10.7% to 11.1% ROE	40%	60%
Over 11.17% to 17.25% ROE	50%	50%
Over 17.25%	0%	100%

The calculation of the ROE under this proposal would be based upon SWB's actual capital structure.

In addition to the continuation of the sharing grid as adjusted for yellow pages, SWB proposed a $22 million rate reduction which includes: (1) expanded Lifeline programs; (2) a reduction in switched access transport prices and the directory assistance intrastate access rate to current interstate levels, and consolidation of the current bifurcated local switch rate into one rate element; (3) a reduction of intraLATA long distance message toll service rates; (4) elimination of toll charges for coin-originated calls from Third and Fourth Tier exchanges in the St. Louis and Kansas City metropolitan areas and the Clever and Billings exchanges in the Springfield area; and (5) the merging of Touchtone prices with local service prices for a reduction of $.20 for residential service and $.33 for business service per Touchtone equipped line.

To correspond with the initial three-year period for the proposed plan, SWB would commit to additional investment in facilities. First, SWB proposes to deploy a digital fiber optic telecommunications system between central offices. In addition, SWB proposes to extend the fiber optic network to reach schools and medical facilities in its service territory which would be capable of providing Distance Learning and Telemedicine. SWB also proposes to accelerate the elimination of party lines and compliance with the Commission's basic local service rule, 4 CSR 240-32.100. SWB estimated its total investment to be $82 million but modified this amount to indicate an additional approximately $55 million to extend the Distance Learning facilities to private schools and to provide on-premises CODEC equipment needed by all schools in its service territory to participate in Distance Learning.

Several parties and participants without intervention support all or part of SWB's alternative regulation proposal. The Intervenors for Independent Options support the modernization portion of SWB's proposal and recommend the Commission adopt the entire proposal to achieve the technological advances these intervenors perceive will occur from SWB's proposal. Specifically, the Intervenors for Independent Options, which are a group of organizations representing people with disabilities and older persons, see the building of the fiber optic infrastructure and provision of Distance Learning and Telemedicine as a step along the path to the reduction of communication barriers for persons with disabilities. These intervenors support new technologies and recommend that these new technologies be designed so that they are accessible to all Missouri residents. These intervenors propose the use of a five-criteria measurement of whether telecommunications technologies are reasonable. These five are: (1) universality, (2) ease of use, (3) accessibility, (4) pricing, and (5) diversity and variety. Based upon these criteria, the Intervenors for Independent Options support SWB's proposal over those of other parties because they see SWB's proposal as opening all areas of SWB's service territory to future video-telephone systems.

The Regional Consortium for Education--Southwest, Missouri Industrial Development Council, Missouri Community Betterment Education Fund, Fredericktown Chamber of Commerce, Farmington Industrial Development Authority, Southwest Missouri Office on Aging, Carroll County Department of Economic Development, Adrian R-3 School District, City of Nixa, Missouri, and St. Louis County League of Chambers of Commerce support the modernization portion of SWB's proposal. These organizations and public entities see the fiber optic infrastructure proposed by SWB as a necessity for the development and attraction of business to their areas. These organizations and public entities see the fiber optic infrastructure as a key in economic development and in creating additional educational opportunities. Only with an adequate telecommunications system, seen by these participants as fiber optic, will the economic future of their communities be aided and their schools be able to increase the quality of their education.

B. Staff's Proposal

Staff's proposal regarding an alternative regulation plan is, first, that the Commission establish just and reasonable rates based upon Staff's complaint case and second, that there be certain modifications to the structure utilized under the experimental plan. The modifications include (1) a change in the ROE percentages that trigger sharing, (2) the plan should last at least three years, and (3) SWB should be required to pay interest on credits for the six months required before customers receive the credits each year. Staff supports SWB's modernization proposal but believes the subsidy for Distance Learning is too great for the mainly speculative participation of schools. Staff recommends that current monitoring procedures remain unchanged except for decisions made in Case No. TO-93-224, for additional reporting requirements for

SWB, and the addition of an exogenous factor adjustment if intraLATA presubscription is ordered.

Staff's proposed grid would be as follows and includes yellow pages imputation:

EARNINGS LEVEL	SHARING PERCENTAGE	
	SWB	Customer
Less than 12.61% ROE	100%	0%
Over 12.61% to 17.61% ROE	50%	50%
Over 17.61% ROE	0%	100%

C. OPC's Proposal

OPC states that it would support an alternative regulation plan if the complaint case is decided first, if earnings sharing levels are fair, if there are periodic reviews which allow for rate reductions, if monitoring procedures are modified to include additional reports; and if quality of service standards are achieved. OPC proposes that a plan should last for a three-year minimum period with extensions. OPC's proposed sharing grid, which includes imputation of yellow pages, is as follows:

EARNINGS LEVEL	SHARING PERCENTAGE	
	SWB	Customer
Less than 10.5% ROE	100%	0%
0-100 basis points above 10.5% ROE	40%	60%
100-500 basis points above 10.5% ROE	50%	50%
Over 500 basis points above 10.5% ROE	0%	100%

D. Other Parties

1. AT&T

AT&T Communications of the Southwest, Inc. (AT&T) generally supports alternative regulation for SWB with sharing at least at current levels and network modernization. AT&T supports network modernization, though, only if it breaks down barriers to competition in the local exchange. AT&T proposes the Commission establish six conditions for competition in the local exchange: (1) unbundle basic network functions, (2) permit comprehensive intervention, (3) establish pricing rules on offering, (4) require nondiscriminatory prices, (5) eliminate restrictions on resale of basic network functions, and (6) require SWB to furnish basic network functions pursuant to technical standards.

2. MICPA

Midwest Independent Coin Payphone Association (MICPA) takes the position that any form of alternative regulation is unlawful and outside the statutory authority of the Commission.

3. MCI

MCI Telecommunications Corporation (MCI) supports alternative regulation for SWB as a means to increase incentives to improve its offerings. These incentives and resulting efficiency, MCI asserts, should allow regulation to more closely mimic competition. MCI proposes that SWB be allowed to file for a general rate increase if earnings fall below a certain level, while a cap should be placed on earnings to protect against unreasonable growth in earnings. If this cap is surpassed over several years, MCI recommends that SWB's rates be reviewed under traditional ratemaking.

MCI proposes modifications to the current sharing grid structure. These modifications would require sharing which begins at the authorized ROR.

The sharing would be 75 percent sharing to customers for the first 100 basis points over the authorized ROE, 60 percent sharing for the next 100 basis points over the authorized ROE, and 50 percent sharing up to the cap. MCI also supports effective monitoring during any plan and restrictions on monopoly rate increases. MCI does not believe there is a necessary link between modernization and an alternative regulation plan and believes that modernization should be evaluated on its own merits, not as a prerequisite or adjunct to alternative regulation.

4. CompTel

Competitive Telecommunications Association of Missouri (CompTel) states that its initial position is that the experimental incentive regulation plan was a failure and an alternative regulation plan should not be allowed. CompTel goes on to state that if the Commission finds a plan reasonable, it should follow the structure proposed by OPC where sharing occurs at any level of earnings above the ROE authorized by the Commission in Case No. TC-93-224. CompTel's sharing grid proposal differs from OPC's in that it recommends the sharing percentages change after a four percent increase in ROE rather than the five percent proposed by OPC. In its reply brief CompTel argues that any alternative regulation plan may not be lawful under current statutes.

5. MCTA

Missouri Cable Television Association (MCTA) takes the position that approval of any form of alternative regulation is beyond the statutory authority of the Commission. MCTA argues that approval of an alternative regulation plan for SWB would be an abdication of the Commission's authority and is clearly beyond the powers vested in the Commission by the legislature. In addition, MCTA argues that sharing earnings through credits is single-issue ratemaking and therefore unlawful. In addition, MCTA asserts that defect in the General

Assembly of bills which would have allowed alternative or incentive regulation indicates that the General Assembly has expressed its will against such forms of regulation. Finally, MCTA argues that the Commission cannot require the general body of ratepayers to fund the Telemedicine and Distance Learning modernization proposals of SWB.

6. Attorney General

The Attorney General takes the position that the Commission does not have statutory authority to approve an alternative regulation plan for SWB because (1) it constitutes retroactive ratemaking, (2) it contains an unlawful moratorium, (3) it creates a variable rate scheme, and (4) it constitutes single-issue ratemaking, which is unlawful. The Attorney General also opposes SWB's modernization proposal as requiring contributions in aid of construction which should not be included in rate base. Finally, the Attorney General argues that even if the Commission finds it has statutory authority to approve SWB's plan, there is not competent and substantial evidence in the record to support the plan.

E. Commission Decision

The parties and participants which have addressed SWB's proposal for alternative regulation have provided the Commission with a thorough analysis of the experimental incentive plan and the purposes for which any future plan may be adopted. The Commission finds that it is necessary to address the issues raised by the parties which relate to the structure of an acceptable alternative regulation plan and the purposes which the Commission feels such a plan would fulfill. The Commission addresses its authority to approve an alternative regulation plan in the Conclusions of Law. The Commission has concluded that it has the necessary authority to approve a reasonably structured alternative regulation plan, as described in this Report And Order, and that a company may voluntarily agree to operate under such a plan.

A quick review of the evidence regarding the experimental plan indicates that it was successful in that it gave the Commission the opportunity to gain experience in regulating a company under procedures different from traditional regulation. The evidence indicates that sharing did occur in the first two years of the experimental plan but not in the third, and that SWB achieved significant ROEs above that authorized in Case No. TC-89-14 in the two years where sharing occurred. The evidence also indicates that relatively few problems arose through the monitoring procedures and any issues which did occur were resolved without requiring a hearing before the Commission. In addition, during the period of the experimental plan SWB made specific network upgrades as required by the agreement establishing the experimental plan.

Some parties contend the experimental plan has not been successful. The main points used to support these contentions are that the percentages upon which sharing was triggered were too high and they allowed SWB to retain excessive amounts of its earnings, and that the network modernization expenditures were no greater under the experimental plan than they would have been without the plan, so ratepayers gained no benefits from the experiment. SWB contends that the experimental plan was a success because modernization of its system was accelerated as part of the plan, quality of service was maintained while basic rates remained stable, and earnings have remained at acceptable levels because of efficiencies it has implemented.

The success or failure of the experimental plan appears to be based primarily on the goals against which a party measures the results under the plan. SWB seems to view the plan as a method of retaining additional profits, while OPC grades the plan's success on the benefits received by SWB's ratepayers. MCI suggests that the plan should be graded based upon the efficiencies accomplished under the plan. The Commission considered all of these factors in reviewing the experimental plan, as well as others. The consideration of all of these factors is consistent with the Commission's obligations under traditional regulation. The Commission is required to balance the interests of both the company and its customers to ensure that safe and adequate telecommunications service is provided at just and reasonable rates. The experimental plan allowed the Commission to fulfill its obligation for a specific period of time under a different regulatory format. As an experiment, the Commission finds the experimental plan was a success. Without the experience under the experimental plan, the Commission would not be able to judge whether SWB's proposed permanent alternative regulation plan is reasonable or what modifications need to be made to a plan to make it reasonable. The Commission finds that the experimental plan allowed it to fulfill its statutory obligation of balancing company and ratepayer interests while maintaining safe and adequate service and maintaining just and reasonable rates.

Claims that SWB earned excessively under the plan and that ratepayers did not receive all of the reductions they were due are offset by the recognition that even under traditional regulation, Commission resource restraints, regulatory lag and the time it takes to audit SWB would have prevented a dollar-for-dollar reduction of earnings for the full three years. The Commission even questions whether an audit and resulting rate reduction would have occurred any sooner than the case ordered in these consolidated cases even if the experimental plan had not been in place. In addition, the Commission questions whether network modernization would have proceeded without the agreements which were part of the experimental plan. The evidence indicates that overall construction budgets for the three years of the experiment may have turned out to have been the same as in prior years, but the question remains whether SWB would have maintained annual investment levels so as to upgrade the plant in outstate areas without the agreement that was part of the experimental plan. The Commission does not believe that SWB's priorities would have been the same without the agreement and the plan.

In addition, the Commission finds that SWB would probably have continued with certain of the efficiencies which occurred during the three years regardless of the experimental plan, but the Commission believes that SWB's management felt less constrained by regulatory oversight to accomplish these efficiencies under the experimental plan. These factors, the Commission believes, render the experimental plan a success and support the approval of a plan as described in this order.

The Commission finds, though, that as has been stated previously, any alternative regulation plan must first be based upon just and reasonable rates as established after a review of SWB's revenue requirement. The Commission has set just and reasonable rates in this Report And Order. The Commission has already indicated that it could not just extend the experimental plan with the modifications as proposed by SWB without first addressing Staff's allegations.

In addition, the Commission finds that it could not adopt SWB's proposed plan on its merits for several reasons. First, SWB's proposal to reduce rates by $22,000,000 is totally unrealistic when weighed against the $84,617,000 reduction found to be reasonable by the Commission. Second, SWB's proposal to maintain the 14.1 percent initial sharing percentage (with yellow pages imputation) disregards the lower cost of debt and changed circumstances which are addressed in the Rate of Return issue. Third, the proposal to discontinue the imputation of yellow pages has been found to be unreasonable and not supported by the evidence. Finally, SWB's modernization proposal clearly would create a subsidy from the general body of ratepayers to an unidentified few educational institutions. Based upon its statutory duty to set just and reasonable rates and the problems inherent in SWB's proposal, the Commission could not adopt that proposal.

Even though SWB has stated rather bluntly that the Commission must accept its alternative regulation proposal or it will return to traditional regulation, the Commission believes that SWB should accept a reasonably structured alternative plan. Regardless of SWB's stated position, it must be aware of the Commission's statutory obligations and it cannot convincingly argue that it expected to continue to be allowed to retain earnings into the future based upon an experimental plan using 1989 financial data. Despite SWB's most optimistic and contentious position, it must have realized that the realities of Missouri law and the almost complete opposition of all interested parties would require an earnings investigation before any alternative regulation plan could be considered.

The Commission has completed its decisions concerning SWB's earnings level and has ordered reductions in rates to reflect what it has found to be a reasonable level of earnings into the future. The Commission, though, considers the revenue requirement decision to be only one-half of the required result of this case. The Commission believes that the experimental plan was sufficiently successful to warrant the adoption of a future plan similar to the experimental plan. The goal of the plan would be to continue the balance between SWB and ratepayer interests established in the complaint case and to allow for efficiencies and sharing of earnings through yearly monitoring. Both ratepayers and SWB should benefit from a reasonable plan. Ratepayers would share in earnings on a regular basis while SWB will have an opportunity to retain additional earnings gained through more efficient operation. The Commission can offer SWB some regulatory forbearance if SWB is willing to operate under a plan with a reasonable structure as described below.

The Commission Accelerated Modernization Plan (AMP) would extend for five years. The Commission has considered the evidence concerning the three-year period of the experimental plan and the necessity to extend the plan and has determined that a future plan should extend beyond three years. Five years would allow sufficient time for SWB to implement any long range plans and would allow a certain amount of stability to SWB operations and rates over a substantial period. The five-year plan could be extended but only after an audit of SWB's earnings in the fourth year. Any complaint case based upon an audit would have to be filed within the month of January 1998 so that any hearings and a decision could be issued before the end of the five-year period, January 1, 1999.

In addition to the audit, reports concerning the AMP would be filed by SWB, Staff, OPC or other interested persons during January 1998. These reports would be considered by the Commission in determining whether to conduct hearings and whether to extend the plan for an additional period.

For this five-year period, SWB would agree to forgo any general rate increases or specific rate increases to basic local service rates, Metropolitan Calling Area service additive rates, Outstate Calling Area service rates, Community Optional Service rates, Touchtone rates, or the access rates or message toll rates reduced as part of Case No. TC-93-224. An exception to the agreement not to raise rates would occur if SWB's ROE fell below 10.72 percent during any year based upon the monitoring procedures established in this Report And Order. Since SWB is not guaranteed a specific ROE, it is not reasonable to allow a general rate case filing until SWB's earnings fall at least 100 basis points below the ROE found to be reasonable in the complaint case. If SWB did file for general rate relief, the AMP would end on December 31 of the year in which the rate case was filed.

The Commission finds that use of a sharing grid is a reasonable method of sharing earnings with customers. The Commission finds the following sharing grid to be reasonable based upon the ROE of 11.72 percent found to be reasonable and the evidence concerning the structure used in the experimental plan.

EARNINGS LEVEL	SHARING PERCENTAGE	
	SWB	Customer
11.72% to 13.22% ROE	100%	0%
Over 13.22% to 14.22% ROE	40%	60%
Over 14.22% to 15.22% ROE	50%	50%
Over 15.22% to 17.22% ROE	25%	75%
Over 17.22% ROE	0%	100%

As can be seen from the above sharing grid, SWB would be able to retain earnings between the authorized ROE of 11.72 percent and 13.22 percent. This structure is similar to the one approved in the experimental plan and is one which the Commission finds more closely reflects rate reductions under traditional regulation. The Commission finds that although sharing of each dollar above the authorized ROE has a certain appeal, it might inhibit SWB from implementing additional efficiencies, and it is not reflective of the way traditional ratemaking works.

Under traditional ratemaking SWB could earn above its authorized ROE until the Commission, after a hearing, authorized a new ROE. During this time lapse between when SWB would begin earning above its authorized ROE and when a new ROE was authorized, SWB would retain all of its earnings. This time lapse would be at least ten to eleven months, but more probably several years. First, SWB's earnings level would have to be sufficiently high over an extended period for the Commission to allocate resources to conduct a full audit. Second, following completion of the audit, proceedings would have to be conducted and a decision issued. During this period, SWB would retain 100 percent of any earnings over its authorized ROE. The Commission finds that it is reasonable to recognize these circumstances in a sharing grid and allow some retention of earnings before sharing would occur.

The sharing percentages and cap in the Commission's sharing grid are based upon the Commission's evaluation of the evidence in this case and the experimental plan. There is no perfect spread between sharing ROEs nor in the percentage of sharing. The Commission's sharing grid, though, does contain a cap above which all earnings will be returned to the ratepayer. This cap is supported by all of the parties and the only contrary proposal was SWB's position that yellow pages imputation should not be included in the sharing grid. Since the Commission has imputed yellow pages to SWB, that imputation would be used in calculating SWB's ROE. The 17.22 percent cap is nearly the same as that approved for the experimental plan, but this cap includes yellow pages imputation whereas the experimental plan's sharing grid cap did not.

The calculations used to determine what SWB's ROE is under the AMP would be based on the decisions reached in TC-93-224. This includes the capital structure found to be reasonable. This same capital structure would remain the same throughout the term of the AMP and would be utilized for all sharing calculations throughout the period of the AMP. Beginning rates under the AMP would be those established in TC-93-224.

The Commission finds that monitoring procedures similar to those approved for the experimental plan, with certain modifications, are sufficient to ensure earnings are properly calculated. The Commission will modify the monitoring procedures of the experimental plan to include the reports listed by Staff witness Goldammer in Exhibit 93, Schedule 3, and OPC witness Robertson in Exhibit 136, page 8. Goldammer provides Staff's proposal for monitoring procedures in Exhibit 93, Schedule 2, Attachment 3. The Commission finds these procedures reasonable, as modified, for the decisions in these consolidated cases, and will adopt them. The evidence reflects that these procedures have permitted calculations with a minimum of disputes. The procedures allow Staff, SWB or OPC to bring unresolved disputes to the Commission for resolution.

The Commission finds that the procedures which allow for unresolved disputes to be brought to the Commission provides a necessary safeguard against abuse of the AMP and a necessary procedure for modifying the plan if circumstances warrant. The Commission does not believe the addition of an exogenous factor is necessary or reasonable. SWB proposes to include exogenous factors of $5 million value or greater, while Staff only proposes one exogenous factor, intraLATA presubscription. The Commission finds that any exogenous factors that SWB, Staff or OPC believe would require a modification of the monitoring procedures can be brought to the Commission for resolution. This will allow the parties to attempt to resolve any disputes concerning the exogenous factor and will allow a full review if no resolution is forthcoming.

The Commission also finds that interest on credits is not reasonable. The credits are paid out approximately six months after the end of each monitoring period because of the necessity for calculation and review. SWB should not be penalized for the delay caused by this procedure.

Even though the evidence indicates that network modernization and alternative regulation are not necessarily connected, and that alternative regulation plans in various states have been approved without any specific modernization proposal, the Commission finds that a commitment to modernization should be a part of the alternative regulation plan. By linking modernization to an alternative plan for SWB, the Commission can be assured that the advantages of a modern telecommunications system are extended to all of SWB's service territory. In addition, SWB asserts that there is a direct link between modernization and the flexibility inherent in alternative regulation, and since SWB is the entity making the investment decisions, some credibility must be accorded SWB's position.

The Commission finds that some major components of SWB's modernization plan which it included in its alternative regulation proposal are reasonable and should be implemented by SWB as part of the AMP. These parts include (1) acceleration of the elimination of party lines from SWB's service territory, (2) acceleration of compliance with the remaining requirements of 4 CSR 240-32.100, to be in full compliance by July 1, 1995, and (3) the construction of a fiber optic infrastructure between central offices. In addition, SWB should install additional fiber optic lines based upon its assessment of the needs for that infrastructure to provide modern telecommunications technology to its customers.

The digital DS-3 fiber system which SWB has indicated it will develop will allow both business and residential customers to have access to a state of the art telecommunications system. DS-3 provides higher band width system to support full spectrum high fidelity audio and higher quality video transmissions. Fiber optic facilities are only minimally affected by noise factors and require regeneration less frequently, which makes them more reliable, with a more stable and clearer signal. The system will position SWB to provide for the anticipated growth in demand for data, image, and video transmissions and provide services such as Sonet (Synchronous Optical Network), video on demand, and picture phone.

The sharing grid approved by the Commission will provide sufficient funds over the five-year duration of the AMP for SWB to fulfill these modernization requirements. The 150 basis points between 11.72 percent and 13.22 percent will generate approximately $18 million a year before any sharing occurs. If SWB's ROE is above 13.2 percent, additional earnings will be available since SWB will be allowed to keep a percentage of those earnings. Over a five-year period SWB will have available, at a minimum, if its performance under the experimental plan is any guide, approximately $90 million to invest in network modernization in Missouri. This amount of investment dollars will allow SWB to install its proposed digital DS-3 fiber optic infrastructure.

The Commission's expectations of SWB's earnings under the Commission's plan are based upon the results achieved by SWB under the experimental plan, which had a higher ROE before sharing occurred. In 1990 SWB achieved a 17.98 percent ROE and shared $22,825,000. SWB's return after the credit was 16 percent. In 1991 SWB achieved an ROE of 17.79 percent and shared $22,228,000 with its customers. After the credits SWB's ROE was 15.90 percent. SWB achieved an ROE of 12.9 percent in 1992 and there was no sharing. These results are illustrative of what SWB can accomplish under an alternative regulation plan and illustrate that SWB should be able to generate sufficient capital to modernize its network over the next five years.

To enable the Commission to monitor SWB's modernization of its network, it will require reports on December 31 of each year of the plan. These reports will describe the upgrades to facilities accomplished during the preceding year and describe projected upgrades for the succeeding year. The reports should include the capital investment made and projected to be made by SWB.

Some parties question fiber optic deployment. The Attorney General, as well as MCTA, OPC and other parties, has raised the issue of whether a broad-band fiber optic network is the logical next step in the deployment of telecommunications technology. The Attorney General and MCTA also question whether SWB should be the proper company to deploy the fiber optic network. Both the Attorney General and OPC presented the testimony of witnesses who supported expanded use of the existing copper infrastructure rather than deployment of fiber.

The evidence presented by the Attorney General and OPC indicates that the existing copper wire could be converted to a narrow band Integrated Services Digital Network (ISDN) at substantially lower cost than a fiber network while achieving similar results. The Attorney General's witness Cooper testified that ISDN could be provided using existing facilities, digital switches, system signaling seven (SS7) and copper wire and that technologies to provide services such as high quality video, high speed data, meter reading, distance learning, medical imaging and home shopping are already in existence. Cooper adds that a large number of ratepayers already have the necessary equipment to utilize the services without expensive additions. Cooper's conclusion is that ISDN should be deployed until broadband fiber optic alternatives become more affordable.

OPC witness Dunkel indicates that two of the three clusters involved in the Missouri Interactive Video projects use DS-1 technology over copper wire. OPC also provided evidence that medical imaging could be achieved using DS-1 and copper wire. The difference between the DS-1/copper and DS-3 fiber optic, OPC asserts, is speed. Dunkel testified that continued development of copper capabilities through compression has greatly expanded the services which could be provided over existing copper facilities.

In addition to the evidence supporting copper wire and ISDN, OPC and MCTA assert that the real purpose of the fiber optic infrastructure proposed by SWB is for the provisioning of future services. Specifically, OPC and MCTA believe SWB intends to offer entertainment and video dial-tone services which will compete directly with cable television and, in OPC's opinion, be unregulated.

The Commission believes deployment of fiber optics is a management decision and should be based upon the needs of SWB ratepayers and SWB's economic analysis of the potential earnings the network would produce. Since the deployment of fiber optics is seen as a management decision, the Commission finds that deployment of ISDN to enhance the usefulness of its copper wire infrastructure is also a management decision. Based upon management analyses, SWB will make decisions concerning the modernization of its network over the next five years. Under traditional regulation as well as under the alternative regulation plan approved by the Commission, a review of SWB's investment decisions will occur in any case involving SWB's revenue requirement. With the testimony provided in this case as well as its own experience, SWB should have sufficient information to reach prudent decisions on network modernization.

The modernization of SWB's network as contemplated by the Commission should address the concerns raised by the intervenors and participants which support fiber optics for economic development reasons. SWB, under the AMP, should modernize its system to allow businesses, institutions and individuals to take advantage of existing and emerging technologies. The Commission does not believe it is statutorily authorized to single out specific groups for special services paid for by the general body of ratepayers. The modernization provided for under the AMP will be for all ratepayers who wish to take the services offered and therefore will benefit all of SWB's service territory.

Deployment of fiber optics remains a management decision, and the company's responsibility for making prudent investment decisions continues. Some of these new services would not be part of basic service and even though they would be noncompetitive under the provisions of Chapter 392, the Commission's pricing decisions in Case No. 18,309 would require that they recover their costs plus provide a contribution to joint and common costs.

The Commission will not require SWB to specifically provide either Distance Learning or Telemedicine as part of the modernization agreed to under the AMP. The installation and construction of facilities capable of providing the necessary services must reflect the overall needs of the ratepayers, not just specific groups. As SWB builds its system, these groups can take advantage of the new services offered.

The Commission also does not share OPC's and MCTA's concerns about the potential for competition between SWB and cable providers. As long as the general body of ratepayers are not required to subsidize this competition, the Commission has no jurisdiction to prevent it from occurring. Even though a potential use of a fiber optic system would be entertainment and video dial-tone services, that does not make it imprudent for SWB to deploy the system. If SWB does deploy a fiber optic system, this reinvestment of dollars generated from Missouri ratepayers under an alternative regulation plan could position SWB ratepayers to compete economically with other areas of the country with similar facilities. However it chooses to modernize, SWB must prepare for the future and the Commission believes that the AMP will allow SWB the flexibility to make investment decisions and should provide adequate earnings to cover the cost of those decisions.

The last matter that has been raised and debated extensively in the evidence is the effect of competition on SWB and whether the level of competition would support an alternative regulation plan. SWB acknowledges that it has stressed the level of competition in its arguments concerning alternative regulation and other issues in these cases. Even if SWB's claims concerning competition are overstated, there is no real question that SWB is facing an increasing level of competition for some services. The Commission has recognized this by classifying SWB's Message Toll Service (MTS), WATS and 800 services, operator services, dedicated private line service, and other services as either competitive or transitionally competitive. In addition, the FCC is continuing to increase competition even down to the local switch by its recent rules on special collocation and switched collocation. How many providers of competing services can economically take advantage of these rules is yet to be seen, but the opportunity for increased competition is being provided.

Whether or not this increased competition requires a move away from traditional regulation, it does require providing SWB with additional flexibility and alternatives to meet competitive pressures. Historically, the Commission has provided flexibility to meet competitive pressures through pricing methods such as those established in Case No. 18,309, and pricing flexibility for specific services, such as Plexar, and more recently by classifying SWB services as transitionally competitive (TC) or competitive (C) under the provisions of Sections 392.361 and 392.370 enacted in 1987. SWB has not yet taken advantage of the pricing flexibility provided by the TC/C classifications.

The Commission views an alternative regulation plan such as the AMP as another method of providing flexibility for SWB to meet the new forms of competition. An alternative plan is not dictated by the level of competition but the Commission, as discussed above, has historically attempted to provide flexibility to meet competitive pressures when it can under its statutory authority. It could be that SWB should avail itself of pricing flexibility under Chapter 392 rather than have an alternative plan approved, but the Commission finds that as long as ratepayers are protected and the method is consistent with the Commission's statutory authority, SWB should be offered different procedures for meeting competition.

This is not to say that the Commission believes that there is a current threat to SWB's local exchange monopoly or to indicate that the Commission is inclined to allow competition in the local exchanges as proposed by AT&T. The Commission, though, believes the changing telecommunications environment requires new approaches to regulation and where consistent with the Commission's statutory obligations, reasonable methods should be approved. The Commission believes that the AMP as described above establishes reasonable procedures for meeting its regulatory responsibilities.

Procedural Issues

Several procedural issues remain to be addressed. These will be addressed here except for the motion to strike a portion of Exhibit 37, page 60A, which has been addressed in the Excess Deferred Income Tax Annualization issue above.

The Commission ruled on several objections to the filing of cross-surrebuttal testimony of SWB to Staff's surrebuttal testimony at the hearing. One objection was taken with the case. That objection was to a portion of Exhibit 25 (SWB witness Barfield) related to step-by-step and crossbar switches. The testimony in question involves the continuation of an agreement by SWB to book additional depreciation reserves up to the unused inside wire amortization to resolve the reserve deficiency associated with Step-By-Step and Crossbar accounts. This agreement was made as part of the calculations for sharing in Case No. TO-90-1, the experimental incentive regulation plan.

Neither party saw fit to discuss this issue in its brief, so the Commission is uncertain whether the issue is still unresolved. The Commission will receive the testimony and will consider the testimony in this case for what it is worth.

The Commission allowed for the filing of exhibits after the hearing by MICPA and SWB. These have been marked as Exhibit 245 and 246, respectively. These exhibits will be received into the record.

The scenarios and responses will be marked as Exhibit 247 and will be received into the record.

MICPA objects to the changes made by AT&T witness Paule in Exhibits 130 and 130P offered by AT&T after the close of hearing and the filing of briefs. No responses were received to MICPA's objection. The Commission will sustain the objection since no party responded and the changes appear to be significant. Substantive changes in the evidence after the close of the hearing cannot be made without allowing additional cross-examination, and the hearing has been concluded, so no cross-examination can be conducted.

All other motions or objections not ruled on specifically will be denied or overruled.

Conclusions of Law

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

The Commission has statutory authority pursuant to Section 386.390 and 392.240 to hear and decide complaints alleging that SWB's rates are unreasonable. The statutes authorize the Commission to file a complaint on its own motion as to SWB's rates and the Commission, by authorizing Staff's complaint, has taken such action. As discussed in the beginning of this Report And Order, SWB has argued that the Commission did not specifically authorize Staff to bring the complaint and so this proceeding has been for nought. The Commission concludes that its actions in accepting Staff's complaint filing, ordering notice and an answer and then establishing a procedural schedule, clearly indicate specific authority to pursue the complaint. In addition, Staff has historically had general authority to pursue complaints against regulated utilities. The Commission also believes that if SWB thought the Commission's actions were beyond its authority, SWB would have sought an extraordinary legal remedy from the Courts to prevent this proceeding from going forward.

The Commission, pursuant to Section 392.240, has authority based upon a complaint to determine whether the rates and charges of a telecommunications company such as SWB are unjust, unreasonable or otherwise unlawful, and it may determine the just and reasonable rates for service of that company.

SWB, as a public telecommunications utility, is subject to Commission jurisdiction under Chapters 386 and 392, R.S.Mo. Under that jurisdiction the Commission is statutorily obligated to consider SWB's rates to ensure they are just and reasonable. The Report And Order in this case includes the Commission's review of SWB's overall revenue requirement and the Commission decisions concerning just and reasonable rates. In compliance with its statutory obligations, the Commission has found that SWB's revenue requirement should be reduced by $84,617,000. This reduction is based upon the Commission's review of all facts presented which have any bearing on a determination of the just and reasonable rates.

In addition, the Commission has found that based upon its responsibility to set rates based upon all relevant factors, it could not approve SWB's proposal to approve an alternative regulation plan as an extension of the experimental incentive regulation plan. The Commission, though, concludes that it has the requisite statutory authority to approve an alternative regulation plan such as the AMP for SWB once it has reached a decision concerning SWB's revenue requirement. Several parties, including the Attorney General and MCTA, have challenged this authority.

The main arguments against the Commission's statutory authority to adopt an alternative regulation plan are: (1) it violates the prohibition against single issue ratemaking, (2) it constitutes retroactive ratemaking, (3) it contains an unlawful moratorium provision, and (4) it creates a variable rate scheme in violation of Section 392.240.

The primary objection to an alternative regulation plan is that it sets rates based upon a single factor, ROE, in violation of the statutory requirement that rates be set based on all relevant factors. UCCM v. PSC, 585 S.W.2d 41 (Mo. banc 1979). In the UCCM case the Missouri Supreme Court held that the Commission could not approve an automatic fuel adjustment clause (FAC) in a company's tariff that would raise or reduce rates based upon one factor, i.e., fuel costs. In this case it is argued that establishing a sharing grid with yearly credits returned to customers based only upon SWB's ROE constitutes single issue ratemaking the same way that the FAC did.

The Commission is very aware of the prohibition against single issue ratemaking, but does not believe the alternative regulation plan as described in this order violates that prohibition. First of all, the alternative regulation plan does not set rates. No rate is changed as a result of the plan and no determination as to the overall level of rates is made. The sharing that would occur under the plan is done through credits to a customer's bill each year. These credits are based upon SWB's ROE but the credits do not result in a rate reduction, nor will rates increase if SWB fails to earn at a certain level. Rates are set as found in this Report And Order and those rates will remain in effect until the Commission reviews SWB's rates in a subsequent general rate proceeding.

Under the terms of the AMP approved by the Commission, Commission Staff will audit SWB's operations in four years to determine whether the rates set in this Report And Order remain just and reasonable. If that audit results in a proceeding before the Commission, the Commission will then again determine a reasonable revenue requirement for SWB and set just and reasonable rates based upon that revenue requirement. The Commission believes this review complies with its statutory duty to ensure SWB's rates remain at a reasonable level. Any other person or group of persons authorized by statute may bring a complaint against SWB's rates during the duration of the plan. Thus, no person is deprived of any statutory right under the approved plan.

The AMP provides SWB some assurance that its rates will remain at a certain level for the duration of the plan, except for complaints by persons other than the Commission. The Commission offers SWB this regulatory forbearance to allow SWB to adopt policies to create efficiencies in its operations and to make additional investments in its infrastructure. Under the terms of the AMP, SWB would voluntarily share, through credits, earnings at certain levels of ROE. The arrangement does not involve the setting of new rates, but only a recognition that customers should benefit from the additional flexibility afforded SWB and the Commission's forbearance.

The sharing by SWB through customer credits is not retroactive ratemaking as described in the *UCCM* case. 585 S.W.2d 58-59. SWB is not ordered to reduce rates or refund past excess profits. The Commission will not order SWB to share its earnings through credits but has offered SWB this alternative to meet the need for flexibility expressed by SWB in this case. The Commission could not order the credits, but it believes that SWB may agree to make the credits as part of its acceptance of an alternative regulation plan such as the AMP.

The Commission is of the opinion that the AMP will not result in variable rates or in unlawful moratoriums. As stated above, the basic rates will not be changed based upon SWB's earnings and only the Commission is prevented from filing a complaint against SWB's rates if the plan is accepted. Regulatory forbearance for a reasonable period is clearly within the Commission's discretion and the Commission believes that under current regulatory conditions, five years is a reasonable period to maintain the rates set in this case.

The Attorney General made the additional argument that allowing SWB to use excess earnings to fund investment under an alternative plan without removing the investment from rate base as a contribution in aid of construction (CIAC), is an abdication of the Commission's responsibility to set just and reasonable rates. The Commission does not believe the theory behind CIAC applies in this situation. Usually CIAC involves either the contribution to a utility by a customer of facilities constructed by the ratepayer or a payment to the utility for construction of facilities to the ratepayer's premises. Here, there would be no direct relationship between any particular ratepayer and any specific investment. The investments made by SWB with any earnings under the plan would be reinvestment of shareholders' return. If the Attorney General's argument were valid, it could be extended to shareholder returns above an authorized ROE even without a plan. This type of shareholder investment in facilities is not CIAC.

Based upon the foregoing conclusions of law, the Commission will order SWB's rates reduced by $84,617,000. The reductions will be to those rates as reflected in the Rate Design portion of this Report And Order. In addition, the Commission has concluded that it could not adopt SWB's alternative regulation plan proposal but will offer SWB, instead, a plan based upon parameters the Commission has found to be reasonable. If SWB agrees to the AMP as approved by the Commission, it may commence operations under the AMP on January 1, 1994.

IT IS THEREFORE ORDERED:

1. That Southwestern Bell Telephone Company shall file, for approval of the Commission, tariffs designed to implement the revenue reduction of $84,617,000 and rate design as described in this Report And Order. The tariffs will be for service rendered on and after January 1, 1994.

2. That Southwestern Bell Telephone Company shall inform the Commission on or before December 28, 1993, if it will agree to the Accelerated Modernization Plan approved in this Report And Order.

3. That Southwestern Bell Telephone Company shall commit, as part of the acceptance of the Accelerated Modernization Plan, to (1) acceleration of the elimination of party lines from SWB's service territory, (2) acceleration of compliance with the remaining requirements of 4 CSR 240-32.100, to be in full compliance by July 1, 1995, and (3) the construction of a fiber optic infrastructure between central offices.

4. That a docket be hereby established for the investigation into Southwestern Bell Telephone Company's affiliate transactions. That docket will be Case No. TO-94-184.

5. That Exhibits 245, 246, and 247 are hereby received into evidence.

6. That the Objection To Post Hearing Change In AT&T Testimony filed by Midwest Independent Coin Payphone Association on October 5, 1993, be hereby sustained.

7. That any objections or motions not specifically ruled on in this Report And Order be hereby overruled or denied.

8. That Southwestern Bell Telephone Company, if it agrees to operate under the Accelerated Modernization Plan approved by the Commission, shall file reports as described in this Report And Order on December 31 of each year of the alternative regulation plan.

9. That Commission Staff shall conduct an audit of the operations of Southwestern Bell Telephone Company during calendar year 1997 if Southwestern Bell Telephone Company accepts the Accelerated Modernization Plan.

10. That any complaint filed based upon the audit ordered in ordered paragraph 7 shall be filed during January 1998.

11. That this Report And Order shall become effective on the 1st day of January, 1994.

BY THE COMMISSION

David L Rauch

David L. Rauch
Executive Secretary

(S E A L)

Mueller, Chm., McClure, Perkins and Kincheloe, CC., concur and certify compliance with the provisions of Section 536.080, R.S.Mo. 1986.
Crumpton, C., not participating.

Dated at Jefferson City, Missouri, on this 17th day of December, 1993.

Glossary of Terms and Acronyms

APBO	accumulated postretirement benefit obligation
ALLTEL	ALLTEL Missouri, Inc., Eastern Missouri Telephone Company, and Missouri Telephone Company (intervenors)
ALLTEL Mobile	ALLTEL Mobile Communications of Missouri, Inc. (intervenor)
AMP	Accelerated Modernization Plan
AT&T	AT&T Communications of the Southwest, Inc. (intervenor)
Attorney General	State of Missouri, at the relation of Jeremiah W. (Jay) Nixon, Attorney General of Missouri (intervenor)
C	competitive
CAPM	capital asset pricing model
CAM	Cost Allocation Manual
CCS7-CCO	Common Channeling Signal Seven-Connecting Central Office
CIAC	contribution in aid of construction
CompTel	Competitive Telecommunications Association of Missouri (intervenor)
COR	cost of removal
CWA	Communications Workers of America, AFL-CIO, CWC (intervenor)
CWC	cash working capital
CWO	Custom Work Order
CyberTel	CyberTel Cellular Corporation (intervenor)
DCF	discounted cash flow
DID	Direct Inward Dial
DOD	United States Department of Defense and All Other Federal Agencies (intervenor)
DOS	Disk Operating System
DS-1	Digital Signal-1
DS-3	Digital Signal-3

EMP	Enhanced Management Pension
EP	Enhanced Pension
EPBO	expected postretirement benefit obligation
ERISA	Employee Retirement Income Security Act
FAS	Financial Accounting Standard
FASB	Financial Accounting Standards Board
FCC	Federal Communications Commission
FERC	Federal Energy Regulatory Commission
FDC	fully distributed cost
GAAP	Generally Accepted Accounting Principles
GHQ	General Headquarters
GNP-IPD	Gross National Product-Implicit Price Deflator
GTE	GTE Midwest Incorporated (intervenor)
IDC	interest during construction
Intervenors for Independent Options	Missouri Alliance of Area Agencies on Aging, Missouri Association of Senior Center Administrators, Missouri Association for the Deaf, and Missouri Council for the Blind (intervenors)
ISDN	Integrated Services Digital Network
ITC	investment tax credit
IXC	interexchange carrier
LEC	local exchange company
LTU	License-To-Use
McCaw	McCaw Cellular Communications, Inc. (intervenor)
MCI	MCI Telecommunications Corporation (intervenor)
MCTA	Missouri Cable Television Association (intervenor)
MEEG	Management Employee Expense Guidelines
MICPA	Midwest Independent Coin Payphone Association (intervenor)
MTS	Message Toll Service

MVS	Multiple Vertical Storage
OBC	One Bell Center
O&M	operation and maintenance
OP 56	Operating Practice No. 56
OPC	Office of Public Counsel
OPEB	other postretirement employee benefit
PBO	postretirement benefit obligation
PTC	primary toll carrier
RBOCs	Regional Bell Operating Companies
ROE	return on equity
ROR	rate of return
RPPP	Reassignment Pay Protection Plan
RTU	Right-To-Use
SBC	Southwestern Bell Corporation
SBYP	Southwestern Bell Yellow Pages
SIPP	Supplemental Income Protection Program
Sonet	Synchronous Optical Network
SPP	Severance Payment Plan
SS7	system signaling seven
SSP	Stock Sharing Plan
STS	Shared Tenant Services
SVA	Stock Value Appreciation
SWB	Southwestern Bell Telephone Company
SWB-Mo	Indicates Missouri-specific operations
TAI	Technical Associates, Inc.
TC	transitionally competitive
TEAM	Team Effectiveness Award for Managers
TPUC	telephone plant under construction