BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

CASE NO. 18,309

In the matter of the cost of service study of Southwestern Bell Telephone Company.

The Commission adopts a telephone pricing policy for three basic categories of telephone service including long-run incremental analysis as the basis for competitive services, residual pricing for basic services, and long-run incremental analysis adjusted for social and economic factors for the balance of services provided by the telephone company. The Commission directs two other cost studies and a rate experiment to be performed by the Company.

APPEARANCES: JAMES A. DAUGHERTY, JACK C. LORENZ and RONALD LeMAY, Attorneys at Law, 100 North Twelfth Boulevard, St. Louis, Missouri 63101, For: Southwestern Bell Telephone Company.

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WILLIAM M. BARVICK, Public Counsel, JAMES M. FISCHER, Assistant Public Counsel, and GREGORY J. CHRISTOFFEL, Assistant Public Counsel, Office of the Public Counsel, P. O. Box 1216, Jefferson City, Missouri 65101, For: The Public.

THOMAS A. HUGHES, Counsel, W. R. ENGLAND, III, Assistant Counsel and BYRON E. FRANCIS, Assistant Counsel, Missouri Public Service Commission, Jefferson State Office Building, Jefferson City, Missouri 65101, For: The Staff.

REPORT AND ORDER

In February, 1975, this Commission decided to establish a generic case for consideration of "a cost of service study." Since that decision and the initiation of this case several prehearing conferences have been held and several position papers and other documents have been filed with the Commission.

By July of 1976 it became apparent that discussing the pros and cons of all possible means of determining costs would be of little value. It was decided to focus the attention of the proceedings on the proposal of Southwestern Bell Telephone Company, hereinafter referred to as "the Company", to use long-run incremental analysis, hereinafter referred to as "LRIA", in the determination of the rates for providing various services to the public. The Company's basic proposal was chosen as the single methodology around which to focus the hearings because the Company has the burden of proving the reasonableness of its rates in proceedings before the Commission and has the initial decision-making responsibility concerning the pricing of its services.

On October 29, 1976, the Commission asked for prepared testimony and exhibits specifically directed to issues delineated by the Commission in "Exhibit A" attached to that order.

A hearing was held March 7 through March 10 at which time the Commission received testimony from nine witnesses and received thirteen exhibits. Numerous other cost studies and information had been previously received by the Commission in this and other dockets.

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.

Even though this case started out to be a "cost" of service study of the Company, it should be stated at the outset that no actual "cost" will or can be determined by this Report and Order. Neither will any prices be determined by this Report and Order. No rates will change at this time, although some rates will change in the future by virtue of the implications of the Commission's decisions in this case.

This Report and Order establishes the framework for future cost and rate determinations for the Company in Missouri. That framework will be of a general nature in part and specific in part. It is not intended to be eternal, but neither is it intended to be ethereal. The Commission desires to set a practical framework for the regulation of the rates for telephone services in this State and as circumstances change, it is assumed that practices and even basic philosophy of telephone pricing may also change. However, for the foreseeable future the basic guidelines set forth in this Report and Order shall apply.

The Commission recognizes three basic categories of service provided by the Company. Category one services are all those subject to substantial competitive pressure. Category two services are all those which are classed as basic telephone service. Category three is made up of the balance of all services provided by the Company.

Examples of service in category one are business and residantial vertical offerings, radio signaling, mobile services, and data terminals. Examples of basic services provided by the Company are basic exchange service, residential and business, and outside base rate area mileage. The Company has encouraged the Commission to state specifically into which various services would fall in order that the Company may have a determination of the categories for study purposes. However, the Commission declines to specify an appropriate category for most services. For example, there may be some residential vertical offerings which are not at this time subject to substantial competitive pressure but which may be very competitive in a few short years. In such a situation, the service presently belongs in category three, but when competition becomes substantial the service should become a category one service. In either case, LRIA applies.

Furthermore, there may be additional basic services belonging in category two. An auxiliary device for the hard of hearing may fall into this group of services. Inasmuch as it is the Company's initial responsibility to price its equipment and inasmuch as the Commission did not have before it all of the various characteristics of the several thousand types of service provided by the telephone company, the Commission must leave to the Company the initial cataloging of all the services it provides.

Category one services will be priced so as to generate the largest practical level of contribution from those services to joint and common costs and to basic services based on LRIA. A price shall not be approved by the Commission which does not allow for some contribution to be made to the joint and common costs of the Company.

Category two services will be priced residually after taking into consideration any contribution to revenue requirement made by category one and category three services. The Company shall have the initial responsibility of bringing forth any economic or social factors used to adjust the relationship between the charges for various basic services.

Category three services will be priced using long-run incremental analysis as a foundation, and adjusting for social or economic factors related to the provision or receipt of those services. The Company shall have the initial responsibility of bringing forth any such factors which it believes should be taken into consideration when adjusting the LRIA price for those services.

The Commission recognizes the radical possibility of the total contribution from category one and category three services exceeding the joint and common costs of the Company and making a contribution to the direct costs of those services in category two. Under the terms of this Report and Order that result is not objectionable.

The Company shall perform an exchange class of service cost study which develops the embedded direct cost for all classes of service under category two. The relationships between those embedded direct costs shall serve as the basic relationship in pricing category two services under the residual technique. The basic price relationships may be modified to recognize specific social or economic factors attendant to the provision or receipt of those basic services. Statewide average ratemaking shall be retained as a pricing principal.

The Company shall also perform an exchange rate group cost/revenue analysis of the rate groups in the present population categories.

The Company shall also conduct a usage sensitive study having as variables at least the time-of-day, time-of-week, and duration of call on a local exchange in the State of Missouri to determine the reasonableness of usage sensitive pricing for basic exchange service. Reasonableness in this case includes but is not limited to a consideration of the magnitude of change in rates, customer acceptance, and cost savings to the Company to be passed through to the customers.

In order that the public may be involved in the establishment of the criteria for the usage sensitive study the Commission will initiate a separate docket number for that study. In so doing, the Commission recognizes the fact that several usage sensitive studies have been started but they have not always been completed. By establishing a separate docket for this study the Commission herewith indicates that it wants this study to be completed so that the data may be available for use by this Commission. It is hoped that the institution of an open docket for the participation of all will in no way slow or preclude the completion of the study. In this situation, the Commission considers that the benefit of public contribution to and understanding of the nature of the study will outweigh the possible detriment of delay or obfuscation.

The Commission is cognizant of the fact that this outline of pricing philosophy will not be implemented overnight. It will, however, expect the Company to move with deliberate speed toward the implementation of this pricing plan. Long-run incremental analysis cannot be performed on every service for every rate case. Interpretations and interpolations will be necessary as time and rate cases march on. Absolute precision is not a goal to be expected. Judgment is a tool to be relied on. The Commission is of the opinion that no other pricing mechanism can come closer to precision and no other pricing mechanism relies any less on judgment.

The Missouri Retailers Association has encouraged the Commission to instruct the Company to use a percentage across the board increase in any rate proceeding in which it does not have data available for the determination of prices of individual services. The Commission does not feel that it is advisable to make such an order in this case. While it may be helpful in some respects, the rate design for the Company which results from the next major rate proceeding filed before this Commission should be set by the Commission hearing that particular proceeding.

The Commission is of the opinion that the guidelines established in this Report and Order provide an appropriate response to the increase in competition in the telephone industry, recognition of the social value of universal telephone service, the rapidly changing technological advancements in the telephone industry, and the desire to establish appropriate pricing principles for the future. To be certain, there will be many variables by which one party or another may desire to modify the costs determined by the long-run incremental analysis of a particular service. With changing circumstances, certain services may change from one category of services to another. However, with the LRIA performed, the cost (in terms of a reduction in contribution to basic services) of modifying any price charged for a particular service can be measured. Even though the nonspecifics of LRIA are a cause for concern on the part of some parties, those nonspecifics are much more specific than the quantification of "value of service", the determination of which is nonquantifiable and the appropriateness of which cannot be confirmed or denied after the fact.

The Commission adopts the definition of long-run incremental analysis as set forth on Company and Staff Joint Exhibit No. 1 filed in this case. That definition is attached hereto as "Appendix A." The Commission generally adopts the proposed method of performing the long-run incremental analysis as set out in Company Exhibit No. 7 filed in this case. As the Company gains in sophistication, econometric analysis may be utilized and improved forecasting techniques developed. Irrespective of any previous or future reference in this Report and Order to LRIA serving as the basis for pricing category one or category three services, where the Company can show that the possible benefits of a full-blown LRIA study are outweighed by the costs of that study the Company may employ a directly assigned cost study methodology. In those instances where the data cannot be made available for a full-blown LRIA study or a directly assigned cost study, another methodology may be utilized.

A small dispute arose between the Company and the Staff concerning the "cost of capital" to be used in the long-run incremental analysis. The Commission hereby instructs the Company that it should use as a component of its LRIA the opportunity cost of money needed to purchase the equipment required for the provision of the service. While it is true that a composite cost could be used and adjusted to reflect changes in risks, the Commission believes that the utilization of the opportunity cost of money would be a more appropriate means of handling the difference in risk characteristics of various services.

Various parties to this case presented arguments against the Company's proposed pricing methodology. Problems associated with the institution of the Company's pricing methodology were also brought out. Some of the opposing argument and problems are discussed below.

The Public Counsel argues that "the Company's proposal should be rejected for the following reasons: (1) the Company's LRIA and residual pricing proposal will fail to provide sufficient data for this Commission to determine whether rates are just, reasonable and not unduly discriminatory; (2) benefits alleged to accrue to basic exchange customers rest upon the highly questionable assumption that non-basic services are making and will continue to make a substantial contribution to common and joint costs; (3) virtually all effective methods for establishing and maintaining accountability to this Commission would be eliminated under the Company's proposal; (4) the Company's LRIA proposal substantially departs from traditional economic theory regarding marginal cost pricing; and (5) the Company would be permitted to earn excess monopoly profits in markets for nonbasic services."

In response to these objections the Commission is of the opinion that: (1) the Company's pricing proposal will provide more data for this Commission in terms of costs and revenues associated with each kind of service, including the effects of cross elasticities for full-blown LRIA studies than it would have available under any other kind of pricing methodology. The pricing of future services would be based on future expectations. Insofar as future expectations are reflective of historic data, projections are no worse than historical data. Insofar as the pricing methodology modifies historical data to more accurately reflect what is expected to occur in the future, it is an improvement on the data available to insure the implementation of just and reasonable rates.

(2) The utilization of LRIA will allow the Commission to determine precisely the contribution, if any, made to common and joint costs. If no contribution is made to common and joint costs then presumably the Commission will not allow the tariff for such a service to become effective.

(3) The Commission is of the opinion that its ability to establish and maintain accountability will be greatly enhanced under the Company's proposal. The retrospective view of the Company's work product in making the applicable costs studies can only result in improved requaltory capability as well as implying a demand for continual improvement of the Company's LRIA methodologies.

(4) All parties agree that marginal cost theory cannot be implemented in practice. The fact that the Company's methodology departs from theory to take into consideration the practical problems associated with the pricing of a complex system of services is an insubstantial argument against the proposal.

The Commission is fully aware of the problems of making market forecasts but it is unpersuaded by the Office of Public Counsel's citation of FCC conclusions. The Commission expects forecasts to vary in degrees of accuracy. The fact that "Telpak" revenues may have been overstated by only ten percent strikes this Commission as a plus rather than a minus. Missing the forecasted rate of inflation for six years from now by ten percent is preferable to not forecasting it at all. There is no testimony in the record of this case that the substitute methodology for pricing proposed by Office of Public Counsel has any basis in fact. All witnesses who testified on the point indicated that fully distributed costs studies have no meaning for the purpose of determining appropriate prices to be charged for telephone service.

It should be obvious that marginal cost theory cannot be applied to all services provided by the Company. Operating within the revenue requirement constraint it is necessary that some service provided by the Company must be priced at something less than incremental costs. The Commission herein has determined that those services to be so priced shall be basic telephone services universally utilized by Missouri's citizens.

(5) "Excess monopoly profits" is a term used by the Office of Public Counsel in its cross-examination of Dr. Alessio. By that term the Office of Public Counsel means the difference between the price set where marginal cost equals marginal revenue and the price located on the demand curve above the intersection of the marginal revenue curve and the marginal cost curve. The Commission is certain that some services presently provided by the Company are priced at such levels at the present time. The extent of that pricing is not known. However, using the Company's proposals will at least quantify the existence of such a situation and the Commission will be in a position to react if it so desires. The Commission finds no inherent evil in pricing certain services in this manner, if it is socially and economically desirable to do so and the composite of the resulting rates is fair, reasonable and not unduly discriminatory.

Intervenor, Missouri Retailers Association, argues that (1) it is no longer appropriate to gear pricing policy to the largely achieved universal service objective; (2) the acceptance of the LRIA framework and the Company's pricing philosophy would mean that, apart from noneconomic considerations, the Commission would lose its power to affect rates for nonbasic services; (3) the forecasting procedures involved in LRIA are so complicated and subjected to varied interpretations that the Commission would find itself with little solid evidence on which to base its decisions; (4) the proprietary interests claimed by the Company on certain features of the proposal would make the proposal incapable of being validly tested by the Public Counsel, Intervenors and other interested persons from whom the proprietary information is withheld; (5) the Company's proposal would fail to provide any information on a number of important cost relationships involving basic service; and (6) inconsistent methodologies would be applied to different categories of the Company's services.

In response, the Commission is of the opinion that (1) while universal service may, at one time have been a goal to achieve it remains a goal to maintain. However, it is equally important that universal service has already been achieved so that the "benefits" of pricing on the basis of long-run incremental analysis of other services can be spread universally through residual pricing of a service which is for most practical purposes universal in application.

(2) Economic considerations would still be permissible in category two and category three services. Economic factors can be taken into consideration by the Commission. Those economic factors, however, most likely would not include other cost relationships, unless the Commission determined that those relationships were essential to the determination of an appropriate rate for a category three service.

(3) Although the forecasting procedures are complicated, they are capable of being understood. Furthermore, they are subject to no more varied interpretations than any other kind of study of costs that it would be possible for this Commission to approve. The Commission is of the opinion that the evidence presented by an LRIA study will be considerably more informative and helpful in establishing future rates for category one and category three services than other types of studies which have been discussed. The Missouri Retailers complain that "the evidence on which the Commission would have to base its decisions would be arbitrary and inconclusive." The Commission knows of no way to study costs that is not arbitrary and inconclusive. As long as the prices are going to have to be established on arbitrary and inconclusive information, however, that arbitrariness should be specified and the extent of the inconclusiveness should be noted. This is possible with an LRIA study. Moreover, the arbitrary and inconclusive character of the information upon which the prices were first established is more easily monitored and later altered.

(4) There are two basic problems associated with the protection of the proprietary interests, if any, claimed for certain features of long-run incremental analysis. The first is whether or not the information can be provided to parties to rate proceedings for their review and consideration. The Commission is of the opinion that this does not constitute a problem insofar as the Company has expressed its willingness to provide the information to the parties to a rate proceeding provided, however, that the proprietary nature of that information is protected.

The problem arises when a party desires to contest a finding or determination made by the Company in its LRIA at a hearing before the Public Service Commission. The Commission's hearings are required to be open and the question arises as to whether it would do any good for a party to have information available to it that it was not able to discuss, interrogate about, or present testimony on in an open forum. The Commission is of the opinion that the open meetings law was not intended to preclude the Commission from acting in the best interests of the public in formulating rates on the best information available to it. The open meetings law, in the opinion of the Commission, was not adopted to preclude certain rate designs and information from being discussed at its hearings. The Commission is of the opinion that should the occasion arise, adequate legal safeguards can be established by this Commission, through and with the cooperation of the courts of this State to insure adequate opportunities to fully discuss any aspect of the Company's LRIA studies.

(5) The Commission has modified the Company's proposal to provide information on cost relationships involving basic services.

(6) Using different methodologies to price different categories of service does not necessarily render the prices charged for services in those categories just, reasonable, or nondiscriminatory; however, neither does it make those rates unjust, unreasonable, or unduly discriminatory.

The Commission agrees with the American District Telegraph Company that the provision of service over 30 Baud private line channels by the telephone company is a monopoly service and is not subject to substantial competitive pressures. The Commission does not agree, however, that the provision of service over 30 Baud channels is a basic service and therefore would classify such service as a category three service which would start with LRIA as the foundation for pricing, to be adjusted by the Commission according to such social and economic factors as the Company in the first instance, and the Commission (with the intervention of American District Telegraph Company) approved in the second instance. The Commission concedes that there are services in category three which are monopolistic services. There are others which are subject to some competitive pressure and there are some, parts of which may be necessary to the provision of basic service. It may well be necessary to adjust the price determined by long-run incremental analysis to reflect varying degrees of these three or other factors. It is not possible to do so on the basis of this record in this case, but in a subsequent rate proceeding the allegations of American District Telegraph Company that the service is a monopoly service, is not discretionary, is necessary to obtain insurance coverage, and is required for economic survival and public safety, are all factors which the Commission will have to take into consideration in determining whether or not to adjust the LRIA price.

The Commission does not feel that the long-run incremental cost portion of the Company's LRIA will indicate a "high" price for the use of 30 Baud private line channels. However, the long-run incremental revenue portion of the LRIA may indicate a substantial price for the provision of the service in order to maximize contribution to joint and common costs of the Company. It is precisely this relationship of revenue contribution versus social contribution which the Commission will have to decide at some future date.

We agree with American District Telegraph Company that any cost analysis performed by the Company should be specific enough to recognize important distinctions in service and cost characteristics of the various types of service provided by the Company.

The City of Kansas City in its brief points out several alleged inconsistencies or problems with the implementation of the Company's LRIA approach. Some of these problems have been addressed previously in this Report and Order.

No one time frame can or should be established for all services provided by the Company. The time frame chosen for incremental analysis should allow for full utilization and implementation of the service to be provided and can only be expected to vary generally between three and six years. Just as one single cost methodology cannot be established for all company services, no time frame for LRIA can be established that will fit all company services.

Although it is certainly possible to divide the broad class of telephone services into two categories, monopoly and competitive, much in the manner that the FCC decided to divide the services, this Commission is not inclined to that same pricing methodology. Therefore, the development of a definition of monopoly and comeptitive services is not necessary. To be sure, this Commission is not unconcerned that some monopoly services should not be priced at as high a rate as LRIA would indicate. That, of course, is the reason why deviation from LRIA for specific social-economic reasons should be allowed.

Certainly one cannot have basic service without the original installation of a telephone. In the Company's recent rate decision by the Commission an increase in installation charges was allowed. However, the charges allowed in that case do not reflect the total costs of installation. This is one means of reflecting the basic service aspect of some of the component parts of "installation-move" charges.

In the instance of charging for directory assistance the Commission, at the request of the Company, handled the situation differently from the installation charges. In the case of directory assistance charges the first five directory assistance requests were provided at no charge as a part of a "basic service" provided by the Company. Every directory assistance call thereafter was priced at cost. These two examples are but two ways in which the social-economic factors may be used to modify LRIA.

It is apparent that the City of Kansas City does not think too highly of the prospect of "a well-intentioned Commission deciding money matters affecting thousands of present and future telephone customers on information developed by Company personnel who would transmit this data as factual, yet not available for review by parties other than the staff, then screened for applicability by an inadequate Commission staff, the staff somehow assuring the Commission of the validity of the approach, refinement of forecast, and detailed analysis of the LRIA structured by the Company."

Even though the Commission does not view this description of the implementation of LRIA methodology as an accurate one it is certainly an improvement over the prospect of a well-intentioned Commission deciding money matters affecting thousands of present and future telephone customers on inappropriate information developed by Company personnel who would develop this data as factual, modified by undefinable values of service, screened for applicability by no one, the staff somehow unable to assure the Commission of the validity of the approach, or of the lack of a forecast or detailed analysis of irrelevant cost data structured by the Company.

Conclusions

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

The Company is a public telephone utility subject to the jurisdiction of this Commission as provided in Chapters 386 and 392, RSMo 1969. The Commission has general supervision over the rates and service provided by the Company under those same chapters.

The Company should establish three basic categories of service for the purpose of establishing a pricing policy in conformity with the findings contained in this Report and Order.

The Company should perform an exchange class of service cost study which develops the embedded direct cost for all classes of service under category two as defined by this Report and Order.

The Company should perform an exchange rate group cost/revenue analysis of the rate groups in the present population categories.

The Company should conduct a usage sensitive pricing study as defined by this Report and Order. Such study shall be set up as a separate docket established by this Commission.

The method of determination of rates proposed by the Company as accepted and modified by the Commission in this Report and Order is just and reasonable and not unduly discriminatory. The rates for telephone service determined by the methodology approved by this Report and Order will be just and reasonable and not unduly discriminatory.

It is, therefore,

ORDERED: 1. That the Company shall move with deliberate speed to implement the pricing methodologies approved by this Report and Order.

ORDERED: 2. That the Company shall perform an exchange class of service cost study in conformity with the provisions of this Report and Order.

ORDERED: 3. That the Company shall perform an exchange rate group cost/revenue analysis in accordance with the provisions of this Report and Order.

ORDERED: 4. That the Company shall conduct a usage sensitive study in accordance with the provisions of this Report and Order.

ORDERED: 5. That this Report and Order shall become effective on the 21st day of June, 1977.

BY THE COMMISSION

Robert L. Gilmore
Robert L. Gilmore
Secretary

(SEAL)

Pierce, Sprague and Jones,
CC., Concur.
Mulvaney, Chm., Not Participating.
Fain, C., Absent.

Dated at Jefferson City, Missouri,
this 27th day of May, 1977.

A DEFINITION OF LONG-RUN INCREMENTAL ANALYSIS

Long-Run Incremental Analysis (LRIA) is a decision making tool, designed to determine and evaluate the impact of alternative courses of pricing action under review by this Commission in its regulation of the telecommunications utilities under its jurisdiciton. LRIA is a decision making tool that is based on microeconomic theory and has been adapted to the practicalities of the non-theoretical world. It is used to assess the anticipated changes in revenue and costs resulting from such developments as: the introduction of a new service, changes in rate and tariff structures, the discontinuation of an existing service and the replacement of an existing service with a new one. Since LRIA deals with expected changes in future revenues and costs resulting from an anticipated change in rate schedules or in the volume of service, it is a forward-looking or prospective decision making tool.

LRIA has two components, Long-Run Incremental Costs (LRIC) and Long-Run Incremental Revenues (LRIR). LRIC is defined as the change in all costs, including the effect on common costs, as a result of adding units of a single service, or adopting an alternative schedule of rates. LRIC considers the direct costs incurred in providing the service, including cost of money, over a sufficiently long period of time as to permit full adaptation of plant capacity. Any costs, including capital costs, that occur in the plant adaptation are accounted for by LRIC.

LRIR is defined as the change in revenue from all services as a result of adding units of a single service, or adopting an alternative schedule of rates, over a period of time sufficiently long so as to allow for a full and complete market reaction. It is important to remember that LRIC analyzes expected changes in future costs, and LRIR analyzes expected changes in future revenues. Consequently both concepts are forward-looking or prospective tools.

The time period of LRIA must be long enough so as to allow for a full and complete market reaction by the consumer and to permit adaptation of the plant and equipment by the Company to the anticipated size of the market.

Although the methodology of LRIA is equally applicable to all telecommunications services, it has been applied traditionally to the non-basic services. The intent has been to generate the largest practical increase in contribution from the non-basic services so as to keep the rates charged for basic services as low as possible. Moreover, the cost of conducting any analysis must be weighed against the benefit expected to be derived from the analysis and only when the anticipated benefits exceed the costs should the analysis be conducted. In this circumstance, a directly assigned, or incremental unit cost study is sufficient.

STATE OF MISSOURI

OFFICE OF THE PUBLIC SERVICE COMMISSION

I have compared the preceding copy with the original on file in this office and I do hereby certify the same to be a true copy therefrom and the whole thereof.

WITNESS my hand and seal of the Public Service Commission, at Jefferson City, this 27th day of May 1977.

Robert L. [illegible]

Secretary