

BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI

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

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) Case No. TR-82-199  
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REPORT AND ORDER

Date Issued: December 30, 1982

Date Effective: January 14, 1983

SOUTHWESTERN BELL TELEPHONE COMPANY

Case No. TR-82-199

Table of Contents

<u>Section</u>	<u>Page</u>
APPEARANCES . . . . .	1
REPORT AND ORDER (Introduction) . . . . .	2
FINDINGS OF FACT . . . . .	4
I. The Company . . . . .	4
II. Elements of Cost of Service . . . . .	4
III. Test Year and True-up . . . . .	5
IV. Net Operating Income . . . . .	5
A. License Contract . . . . .	5
1. Proposed Disallowance of "Ownership Costs" . . . . .	6
2. Proposed Capitalization and Amortization . . . . .	12
a. Capitalization of AT&T General Department Expenditures . . . . .	13
b. Bell Laboratories Research and Systems Engineering . . . . .	13
3. Summary . . . . .	17
B. Business Information Systems (BIS) . . . . .	17
C. Conduit and Cost Sharing . . . . .	20
D. Western Electric Profits . . . . .	23
E. Discounted Telephone Service . . . . .	29
F. Test Year Uncollectibles . . . . .	31
G. Operating Uncollectible Revenues Gross-up . . . . .	32
H. Loaned Employees/United Way . . . . .	34
I. Capitalized Property Taxes . . . . .	37
1. Materials and Supplies (M&S) . . . . .	37
2. TPUC, and Plant Booked Directly to Plant in Service . . . . .	38
J. Rate Case Expenses . . . . .	39
K. Income Taxes . . . . .	40
1. Interest Expense . . . . .	40
a. Interest Related to Telephone Plant Under Construction (TPUC) . . . . .	40
b. Interest Related to Job Development Investment Tax Credits (JDITC) . . . . .	41
c. Interest Related to Intrastate Capital Structure . . . . .	43
2. Normalization Versus Flow-through . . . . .	43
V. Rate Base . . . . .	46
A. Short-term Telephone Plant Under Construction (TPUC) . . . . .	46
B. Plant Booked Directly to Plant in Service (Account No. 100.1) . . . . .	47
C. Uncollected Depreciation and Deferred Taxes . . . . .	49
D. Western Electric Profits . . . . .	49
D. Original Cost Rate Base . . . . .	49
VI. Fair Value Rate Base . . . . .	49

<u>Section</u>	<u>Page</u>
VII. Rate of Return . . . . .	50
A. Total Rate of Return . . . . .	50
1. Capital Structure and Embedded Cost of Debt and Preferred Stock . . . . .	50
2. Return on Common Equity . . . . .	53
B. Intrastate Rate of Return . . . . .	57
C. Summary . . . . .	62
VIII. Separations . . . . .	63
A. Interstate Foreign Exchange . . . . .	63
B. Five-day Versus Seven-day Studies . . . . .	67
C. Frozen Subscriber Plant Factor (SPF) . . . . .	70
D. Phasedown of Customer Premises Equipment (CPE) . . . . .	71
IX. Settlements . . . . .	73
X. Quality of Service . . . . .	73
XI. Capital Recovery . . . . .	75
A. Expensing Station Connections (ESC) . . . . .	75
B. Straight Line Equal Life Group and Remaining Life Depreciation . . . . .	84
XII. Hotel and Motel Commissions . . . . .	84
XIII. Revenue Requirement . . . . .	85
XIV. Rate Design . . . . .	85
A. P.S.C. Case No. 18,309 . . . . .	85
B. Specific Rate Design Issues . . . . .	87
1. Directory Assistance . . . . .	87
2. 25-cent Coin Phone Calls . . . . .	90
3. Centrex C.O. . . . .	90
4. Direct Inward Dialing . . . . .	91
5. Directory Listings - Schedules . . . . .	92
6. WATS Restructure; Resale and Sharing of WATS Services . . . . .	92
7. Centrex C.U./Package PBX . . . . .	94
8. Local Conference Calling . . . . .	95
9. Hotel/Motel Station Line Rates and Toll Commissions . . . . .	95
10. Private Lines/OCC . . . . .	97
(a) OCC . . . . .	99
(b) Nonrecurring Private Line . . . . .	99
(c) Interexchange Private Line . . . . .	100
(d) Intraexchange Private Line Rates . . . . .	102
(e) Private Line Resale and Sharing . . . . .	105
11. General Exchange/Vertical Services/IUC Studies . . . . .	106
12. Local Exchange/OBRA Mileage . . . . .	107
13. Unrecovered Telephone Equipment Charge (UTEC) . . . . .	109
14. Toll . . . . .	110
15. Exception Tariffs . . . . .	111
16. Sale of Installed Base Equipment to Customers . . . . .	111
17. "Tier A" Charges for Terminal Equipment . . . . .	113
18. Category Cost of Service Study . . . . .	115
19. Customer Billing . . . . .	118
C. Rate Design Summary . . . . .	119
XV. Public Counsel Motion For Separate Docket . . . . .	120
XVI. Treatment of Rate Effects of Computer Inquiry II . . . . .	123
XVII. Test Years in Future Rate Cases . . . . .	127
CONCLUSIONS . . . . .	128

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

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#### REPORT AND ORDER

On February 16, 1982, Southwestern Bell Telephone Company filed with the Commission proposed revised tariff sheets designed to permanently increase annual revenues for intrastate telecommunications services in the State of Missouri by \$147.1 million. The proposed tariffs bore a requested effective date of March 18, 1982. By its "Suspension Order" issued February 23, 1982, the Commission suspended the revised tariff sheets for 120 days beyond March 18, 1982, until July 16, 1982, and assigned Case No. TR-82-199 to the proposed tariff sheets. On March 23, 1982, the Commission further suspended the revised tariff sheets for six months beyond July 16, 1982, until January 16, 1983.

The complete procedural history of the case is summarized in the Hearing Memorandum in this case, Joint Exhibit No. 3.

Local public hearings were held in this case on August 16, 1982, at Sedalia, Missouri; on August 20, 1982, at Springfield, Missouri; on August 23, 1982,

at Kansas City, Missouri; on August 26, 1982, at Cape Girardeau, Missouri; and on August 27, 1982, at St. Louis City and St. Louis County, Missouri. The Company provided notice of these local hearings to its customers as directed by the Commission and in compliance with 4 CSR 240-2.110(12).

The formal evidentiary hearings in this case were held in the Commission's hearing room in Jefferson City, Missouri, commencing on September 20, 1982, and concluding on October 8, 1982.

The United States Department of Defense (hereinafter, Defense), the State of Missouri (hereinafter, State), St. Louis County, Missouri, the City of St. Louis, Missouri, the Missouri Hotel and Motel Association (hereinafter, Hotel and Motel), the Missouri Retailers Association, Missouri Public Interest Research Group (hereinafter, MoPIRG), American District Telegraph Company, the City of Trenton, Missouri, the Missouri Alarm Association (hereinafter, MAA), and General Telephone Company of the Midwest were granted leave to intervene in this proceeding. Subsequently, the Missouri Retailers Association and American District Telegraph Company withdrew from the case. The Staff of the Public Service Commission, and the Office of Public Counsel, also fully participated in this case.

A true-up hearing was held in the Commission's hearing room in Jefferson City on November 23, 1982, pursuant to Section XI (pp. 17 through 24) of the Hearing Memorandum in this case (Joint Exhibit No. 3).

Upon the conclusion of the presentation of evidence in this matter, a briefing schedule was established calling for the submission of simultaneous initial briefs by the parties to this proceeding on or before October 29, 1982, and the filing of simultaneous reply briefs on or before November 12, 1982. Subsequently, the dates were modified to November 1, 1982, for the filing of initial briefs, and November 15, 1982, for the filing of reply briefs. Initial briefs were filed by the Company, the Staff, Public Counsel, the City of Trenton, the Department of Defense, Missouri Hotel and Motel Association, Missouri Alarm Association and the State of

Missouri. Reply briefs were filed on behalf of the Company, the Staff, Public Counsel, Missouri Hotel and Motel Association, Missouri Alarm Association, and the Department of Defense.

### Findings of Fact

#### I. The Company

Southwestern Bell Telephone Company (hereinafter referred to as SWB, Southwestern Bell or Company) is a public utility corporation duly organized and existing under the laws of the State of Missouri. Southwestern Bell is a telephone corporation as defined in Chapters 386 and 392, R.S.Mo. 1978, with its headquarters and principal place of business located at 1010 Pine Street, St. Louis, Missouri. Southwestern Bell is a wholly-owned subsidiary of American Telephone & Telegraph Company (AT&T) and is one of the Bell System's 23 operating companies. SWB provides telecommunications services throughout the states of Missouri, Kansas, Arkansas, Oklahoma and Texas. As of April 30, 1982, the Company had approximately 1,500,000 customers in the State of Missouri located in 166 exchanges. The Company serves approximately 3,200,000 telephones in its exchanges and, as of the end of the test year in this case, had a work force of some 14,686 employees. Southwestern Bell's Missouri intrastate operations are subject to the jurisdiction of this Commission.

#### II. Elements of Cost of Service

Southwestern Bell's authorized rates are generally based on its cost of service or revenue requirement. As elements of its revenue requirement, the Company is authorized to recover all of its reasonable and necessary operating expenses and, in addition, a reasonable rate of return on the value of its property used in public service. It is necessary, therefore, to establish the value of the Company's property and to establish a reasonable rate of return to be applied to the value of its property or rate base which, when added to the operating expenses, results in the total revenue requirement of the Company. By calculating the Company's reasonable level of earnings, it is possible to determine the existence and extent of any

deficiency between the present earnings and any revenue requirement to be allowed as additional revenue in any rate proceeding.

### III. Test Year and True-up

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

All of the parties to this proceeding have agreed to utilize as a test year the 12-month period ending April 30, 1982, as updated for known and measurable changes through September 30, 1982. The updating methodology and procedure was agreed to in the Hearing Memorandum (Joint Exhibit No. 3), Section XI, at pages 17 through 24. Staff and Company performed a "true-up" audit designed to recalculate Staff's and Company's presentations based upon actual operating data for the 12 months ending September 30, 1982. The results of this true-up audit were presented to the Commission at the true-up hearing on November 23, 1982. The record of that hearing and the results of the true-up audit constitute a portion of the record in this case.

### IV. Net Operating Income

#### A. License Contract

The Company has included in its test year expenses in this case \$16,928,771 for services rendered to it by American Telephone & Telegraph Company (AT&T) under the License Contract. Under the License Contract, AT&T agrees to provide to the Bell Operating Companies (BOCs), including Southwestern Bell, the use of patents; to conduct research on behalf of BOCs; and to provide advice and assistance to the BOCs. Some of these services are provided by the AT&T general departments, and some by Bell Telephone Laboratories (hereinafter, "Bell Labs"). Bell Labs is owned 50 percent by AT&T and 50 percent by Western Electric Company. The function of Bell Labs is to

conduct research, systems engineering, development and design work for systems. Western Electric Company is entirely owned by AT&T. Western's function within the Bell System is to manufacture, purchase, install and repair apparatus, equipment and supplies used by the System. AT&T also owns a majority of the capital stock of Southwestern Bell and all of the Bell Operating Companies except two. AT&T further owns and operates the long distance network of the Bell System through the Long Lines Department.

In the instant case, the Staff and Public Counsel recommend the disallowance of \$4,132,663 of the Company's operating expenses which Staff and Public Counsel believe are ownership costs related to AT&T's function as a "holding company". The Staff further recommends the capitalization and amortization of \$6,194,142, which Staff believes represents "product-related" costs, current expenditures benefiting future periods, or similar costs that Southwestern Bell would capitalize itself. Public Counsel proposes that, of the \$6,194,142 which Staff proposes to capitalize and amortize, the \$4,418,424 relating to Bell Labs' R&SE should be disallowed entirely as "product-related" costs which benefit Western Electric. The Company opposes the adjustments recommended by the Staff and Public Counsel, both in principle and amount.

1. Proposed Disallowance of "Ownership Costs"

It is Staff's position that AT&T uses the License Contract to recover costs related to activities motivated by and serving the 100 percent ownership interest of the BOCs, including Southwestern Bell. The crux of Staff's position is that AT&T is a "holding company", as well as a provider of services to the BOCs, and that part of the License Contract expense of Southwestern Bell is used for the performance of AT&T's ownership or holding company function. Because of the License Contract, Staff contends, AT&T absorbs no "ownership costs" to be offset against investment income. The BOCs, including Southwestern Bell, should not bear these "ownership costs" through the License Contract, in Staff's view.

Staff seeks the disallowance of the following operating expenses in this case which Staff identifies as being holding company or ownership costs: (1) below-the-line expenses; (2) taxes incurred to run a holding company; (3) antitrust costs; (4) costs incurred to run a holding company; (5) costs incurred to form American Bell, Inc., and position the Bell System for divestiture; and (6) costs associated with HR 5158 (proposed legislation in the United States House of Representatives).

Public Counsel presented evidence recommending 100 percent disallowance of License Contract expenses associated with: (1) the corporate accounting and auditors' fees segments of the Comptroller's Department; (2) the directors' fees, annual report and stockholders meetings segments of the Executive Department; (3) departments whose primary activity is to enhance shareholder relations or protect shareholder interests in AT&T, as determined from budget decision packages; (4) AT&T's participation in the Department of Justice antitrust suit against AT&T; and (5) the Public Affairs Department and various charitable contributions made by AT&T. Staff, Public Counsel and the Company all concur in this last disallowance. Public Counsel asserts that the expenses relating to items (1) and (2) are primarily related to furthering AT&T's holding company interests rather than providing advice and assistance to the BOCs. Public Counsel agreed with the Staff's reasoning for its proposed disallowance of costs associated with the Department of Justice antitrust suit. Public Counsel also recommended a 50 percent disallowance of License Contract expenses associated with departments which provide a significant amount of advice and assistance while at the same time serving holding company functions.

However, in the Hearing Memorandum (Joint Exhibit No. 3), Public Counsel has joined in Staff's recommended disallowance of alleged holding company costs.

Public Counsel analogizes the ownership costs incurred by AT&T in managing its investment in the BOCs to the expenses incurred by a mutual fund in managing its portfolio. In the case of a mutual fund, these management expenses are paid by individuals who invest in the fund rather than by the companies in which the

fund holds shares. Similarly, Public Counsel asserts, it is AT&T and not the BOCs which should properly bear the management or ownership costs associated with the former's investment in the latter. AT&T does function as a centralized general administration with the goal of protecting the integrity of the shareowners' investment. As a general rule, control of the BOCs by the AT&T general departments will be the greatest in matters directly affecting shareholders. The BOCs do not have control over License Contract expenditures. Further, AT&T has never permitted a representative from a BOC to sit on the corporate committee which has exclusive authority to allocate the costs of License Contract expenditures. An additional element of AT&T's ownership function in relation to the BOCs is the fact that AT&T requires Southwestern Bell to submit annual "five-year plan" budgetary documents containing the Company's proposed earnings estimate for the upcoming year. After reviewing this document, AT&T recommends the earnings levels to be attained by the Company during the subsequent year.

Prior to 1974, the method of billing under the License Contract resulted in deficits to AT&T requiring the absorption by AT&T of a portion of the General Department costs, which then were offset against investment income. This absorption of ownership costs was eliminated in 1974 when AT&T changed to a 100 percent allocated-cost basis for billing under the License Contract. Therefore, since 1974 all costs are deemed to be incurred by AT&T to provide centralized services to the BOCs, and ownership costs are no longer recognized by AT&T.

Southwestern Bell's original filing in this case placed two elements of its License Contract payment "below the line", i.e., not to be included in the net operating income (NOI) amount used to determine the revenue requirement of the Company. Those two elements of the License Contract payment related to contributions, and AT&T's Public Affairs Department (which engages in lobbying). Both Staff and Public Counsel accepted these two disallowances, as does the Commission.

The second item (taxes incurred to run a holding company) contains two elements: the allocated costs of (1) New York State franchise taxes, and (2) the factor-up for federal income taxes on the return on investment. Staff has proposed that Southwestern Bell recover that portion of franchise taxes allocated to those AT&T assets in New York that are necessary for the provision of advice and assistance to the BOCs. Thus, Staff is not proposing a 100 percent disallowance of New York State franchise taxes. It is apparent that AT&T's total New York State franchise tax expense is not attributable to the provision of License Contract services to Southwestern Bell, and that AT&T's ownership of New York Telephone Company is a substantial basis for the tax. The Commission finds and concludes that the Company has failed to meet its burden of proving that the portion of the License Contract expense related to New York State franchise taxes which Staff seeks to disallow is just and reasonable. Staff's adjustment is therefore approved.

Staff also contends that it is not appropriate to include an income tax factor-up because the assets employed in furnishing License Contract services provide AT&T with tax benefits sufficient to offset any tax liability. If this portion of SWB's License Contract expense were allowed, it would permit AT&T to pass through to Missouri ratepayers via the License Contract the effects of normalization of a tax timing difference when the Commission has determined that flow-through of such benefits is the preferred method for SWB in this case. (See Section IV.K.2, below). The Commission finds and concludes that since it has determined herein that flow-through treatment should apply to SWB tax timing differences which are not restricted by the IRS, it would be inappropriate to allow AT&T to recover from Missouri ratepayers the effects of normalization of this item through the License Contract.

Concerning "antitrust costs", the Staff contends that Southwestern Bell is being billed through the License Contract for AT&T's defense of the antitrust lawsuit filed by the United States Department of Justice in 1974 which resulted in 1982 in what is widely known as the Modified Final Judgment (MFJ), discussed in more detail

below in Section XV, "Public Counsel Motion For Separate Docket". Staff argues that AT&T's defense of this lawsuit is a direct result of its ownership of subsidiaries such as SWB. The Staff contends that this integrated structure, and not the provision of advice and assistance, is the basis of the lawsuit. The Staff further contends that AT&T's defense was primarily conducted for the long-range benefit of AT&T and not of SWB. Indeed, the decision to settle the lawsuit and divest the BOCs was made by AT&T without input from Southwestern Bell.

The Commission finds and concludes that the Company has failed to meet its burden of proving that the inclusion in Missouri intrastate rates of License Contract expenses related to AT&T's defense of the Department of Justice antitrust suit is just and reasonable. The Commission notes that this determination is consistent with that of a number of other state regulatory commissions.

The Staff identifies various AT&T costs as "costs incurred to run a holding company": (1) public relation and employee information costs that are associated with Bell System exhibit, display and informational material; (2) comptrollers' costs for performance of corporate accounting; (3) treasury costs which service securities; (4) secretary costs; and (5) executive costs associated with director fees, annual reports and stockholders meetings. Staff proposes to disallow only 50 percent of these expenses, in order to give weight to the duality of AT&T's relationships with SWB as both owner and service company. The Commission finds and concludes that the Staff has identified particular categories of costs which are, in part, associated with AT&T's corporate function as an owner of subsidiary companies, including Southwestern Bell. In the absence of any evidence that a more precise allocation can be made within the accounts identified by the Staff between holding company costs and costs related to AT&T's service function, the Commission finds and concludes that the 50 percent disallowance of such costs is a reasonable allocation. This determination is consistent with the Commission's findings in P.S.C. Case No. 18,660 (December 1976), P.S.C. Case No. TR-79-213 (March 1980), and P.S.C. Case No. TR-81-208 (November 1981).

Staff further contends that AT&T is currently engaged in activities designed to prepare itself for the start-up of American Bell, Inc. (the fully separated subsidiary or FSS required by the FCC's decision in Computer Inquiry II), and divestiture of the BOCs as required by the Modified Final Judgment. The Staff asserts that some of these costs are being funded by SWB through the License Contract. The following AT&T general departments are primarily associated with the FSS: Business Marketing, Business Services, and Residence Marketing and Services. While AT&T has excluded \$4.9 million from these departments, it has collected \$125.8 million through the License Contract from these three departments for the year ending February 1982. These three departments will report to the head of the new FSS. The Commission finds and concludes that License Contract expenses related to those three general departments should be excluded from Southwestern Bell's operating expenses in order to prevent AT&T from recovering costs associated with an unregulated subsidiary from SWB's regulated ratepayers.

Further, AT&T has not excluded any MFJ costs from the License Contract. The Directory and Material Logistics general departments are associated with the divestiture or MFJ. Further, all AT&T general departments made contributions to the development of AT&T's Divestiture Guidelines and the costs associated with these guidelines were not excluded from the License Contract by AT&T. The Commission finds and concludes that these License Contract expenses of SWB should be disallowed as operating expenses in this case. The Company has not met its burden of proving that License Contract expenses related to the formation of the FSS and to preparation of the Bell System for divestiture are just and reasonable for inclusion in the rates of Missouri ratepayers.

Staff also identifies costs incurred by AT&T to oppose legislation proposed in the United States House of Representatives (HR 5158, the "Wirth Bill") as an example of AT&T holding company or ownership costs which should not be allowed in SWB's License Contract expenses. Staff presented testimony on that subject in order

to buttress the Staff's argument that AT&T acts as a holding company. However, Staff did not recommend an adjustment to License Contract expense for this item, since those expenses were excluded from License Contract billing.

In summary, the Commission finds and concludes that AT&T, as the owner of Southwestern Bell, does exercise ownership and management functions with regard to Southwestern Bell, and that AT&T's relationship with Southwestern Bell is, in part, in the nature of a holding company. The Commission further finds and concludes that the operating expense adjustment proposed by the Staff relating to License Contract expenses paid by Southwestern Bell to AT&T for ownership costs is just and reasonable, and should be approved.

## 2. Proposed Capitalization and Amortization

In addition to its proposed exclusion of certain License Contract expenses as just discussed, the Staff proposes as well to capitalize certain AT&T General Department expenditures which Staff asserts will benefit future periods and are therefore capital in nature; and capitalize a portion of Bell Telephone Laboratories' (Bell Labs) Research and Systems Engineering (R&SE) expenditures billed through the License Contract. The Staff argues that some benefits of current General Department and R&SE activities will be realized in the future and that their costs, therefore, should be spread over the periods benefited. Staff also argues that a portion of the costs which it seeks to have capitalized are in part "product-related", i.e., research costs related to the development and manufacture of products which, when conducted by a competitive manufacturer, must be recovered through the price of the product sold. In addition, Staff's proposal is designed to eliminate the inconsistency in Company's existing accounting for construction-related costs which, when incurred directly by SWB, are partially capitalized on the books while the same types of costs, when incurred by AT&T and flowed through the License Contract, are charged to current expense.

a. Capitalization of AT&T General Department Expenditures

A portion of AT&T General Department activities are devoted to the centralized planning and design of telecommunications facilities and the overall administration of Bell System operations, including construction management at the System level. The costs of these activities are analogous to the engineering and administrative construction overhead costs that are incurred on a more localized level directly by Southwestern Bell and which are capitalized by Southwestern Bell. Included within this description are certain activities of the AT&T General Department, namely: Network Segment of Network Services, Planning and Design; Financial Accounting; Distribution Plant; and Methods For Distribution and Central Office Services. Public Counsel supports the Staff's proposal on this subissue, which would result in the capitalization of \$1,775,718 of AT&T General Department expenses paid by SWB through the License Contract.

The Commission finds and concludes that Staff's proposal is reasonable and should be approved. This portion of SWB's License Contract expense is directly related to activities of construction engineering and supervision. If those activities were performed by SWB, the costs would be capitalized in recognition of the capital nature of such costs. To allow such costs to be expensed when provided to SWB and paid for by SWB through the License Contract, would be inconsistent and unreasonable. Further, since the benefits of these activities will be enjoyed in future periods, capitalization is appropriate.

b. Bell Laboratories Research and Systems Engineering (R&SE)

Bell Labs was formed as a corporate entity in 1925 in order to provide the technical expertise required to operate the Bell System. As stated previously, Bell Labs is owned 50 percent by AT&T and 50 percent by Western Electric, and Western Electric is owned entirely by AT&T. Research and Systems Engineering (R&SE) work at Bell Labs includes engineering the network to meet demand and to introduce new technologies for growth, improved service or reduced costs. R&SE also includes

undertaking research to understand basic scientific principles which have traditionally been applied to improve products or processes in periods subsequent to fundamental discoveries. Under the present License Contract billing arrangement, all R&SE costs incurred by Bell Labs are allocated to AT&T's Long Lines Department and to the BOCs, rather than to Western Electric, on the premise that such activity is unrelated to product development and principally benefits the BOCs. Bell Labs also performs functions which are designated as Specific Design and Development (SD&D). Bell Labs' SD&D work is funded by Western Electric.

Staff and Public Counsel allege that there is a direct relationship between the SD&D work funded by Western Electric and the R&SE functions to which Southwestern Bell contributes through the License Contract. Therefore, those parties allege that a significant portion of R&SE activity is inseparable from the product development process. Staff urges that the portion of SWB's License Contract expense which is related to R&SE activities at Bell Labs should be capitalized. Public Counsel, on the other hand, urges that those costs be disallowed in their entirety rather than capitalized.

Staff examined R&SE and SD&D case authorizations. Its review of SD&D case authorizations was conducted at Western Electric's premises in New York. In addition, Staff reviewed technical papers and memoranda pertaining to R&SE and SD&D cases at Bell Labs' locations in New Jersey. Staff concluded from its audit that the purpose of Bell Labs is to produce marketable products since, in Staff's opinion, the majority of work performed at Bell Labs is directly focused for ultimate application on telecommunications products. Bell Labs' scientists may work on R&SE cases at one time and SD&D cases at another. Bell Labs' scientists who worked on R&SE cases studied by the Staff or were on the copy distribution list for such cases were also on the copy distribution list for the counterpart SD&D cases. Staff contends that a continuum exists between R&SE and SD&D which the Company does not acknowledge. To the degree that nonspecific research (part of R&SE) benefits the telecommunications

user, it invariably does so through telecommunications products and systems. The R&SE activities charged to the BOCs are the forerunners of SD&D activities charged to Western Electric. In general, any telecommunications product manufacturer other than Western would include all research costs, to the extent that the market will bear them, in the price of their products. Staff asserts that such R&SE costs incurred by SWB through the License Contract should be recovered over a period of years through capitalization since their purpose is the development of products which will produce future benefits. Public Counsel, on the other hand, asserts that all of these R&SE costs should be recovered by Western Electric through the price of its products, as would be true for other manufacturers, rather than by Bell Labs through the License Contract. Staff's witness agreed that "in a strict accounting sense", the total cost of research, design, market planning, manufacturing, distributing and selling a given product should be recovered through its price.

It is also Staff's position that AT&T general departments perform product-related work through their product team and product life cycle management activities and by acting as central coordinator for Bell System product introduction, planning and management. However, Staff does not propose to capitalize the general departments' product activities because they cannot be quantified.

An additional reason for its proposed capitalization treatment of Bell Labs' R&SE costs is Staff's rationale that if the Bell Lab activities related to these costs were conducted by SWB on a local level, capitalization treatment would be accorded by the Company.

Public Counsel, on the other hand, urges that complete disallowance of the product-related costs will help to ensure that Western Electric does not receive an unwarranted competitive advantage in the sale of its products to the BOCs. The charging of a portion of Western's product-related costs designated R&SE to the BOCs could permit Western to reduce the price of its products and obtain a competitive price advantage over other manufacturers of comparable products. Public Counsel

suggests that its proposal would produce better matching between the cost of research and product development and the benefits produced therefrom. Public Counsel also asserts that it would be inappropriate to either expense or capitalize product-related costs at this time, in light of the Modified Final Judgment resulting from the Department of Justice antitrust suit against AT&T, since there is presently no assurance that the BOCs will receive any financial recognition for their funding contributions to those R&SE projects which will eventually result in Western Electric products, absent the rights guaranteed under the License Contract, after the MFJ is implemented. The MFJ does provide, however, that the BOCs will continue to have some form of priority access to Bell Labs and Western Electric for a five-year period after the License Contract expires.

SWB has presented various arguments in support of its position that R&SE costs under the License Contract should be treated by this Commission as a current expense. The Company asserts that expensing of these types of costs is consistent with generally accepted accounting principles (GAAP) and that capitalization treatment is warranted only when specific benefits can be associated with expenditures in specific future periods, and where ultimate future recovery of such costs is not in doubt. Southwestern Bell also asserts that R&SE work is conducted by Bell Labs without anticipating new or improved future products (as contrasted with SD&D activities on behalf of Western Electric), but that R&SE work has as its purpose research to assure the timely availability of knowledge and activities designed to find the most efficient way to utilize resources and to plan and operate the Bell System network.

The Commission finds and concludes that the R&SE work performed by Bell Labs is not separable from the AT&T product development process. While the evidence indicates that all of the R&SE work performed by Bell Labs is not focused upon the introduction of specific products in the same manner as the SD&D work conducted for Western Electric, that work is nonetheless clearly interrelated. In the context of

the organization of the Bell System, and specifically considering the interconnected relationship of Western Electric, Bell Labs and the Bell Operating Companies, the Commission concludes that the evidence presented supports a finding that the R&SE work conducted by Bell Labs and billed through the License Contract cannot reasonably be considered separate and distinct from the Bell System's product development process.

The Commission further determines that capitalization treatment is appropriate for the costs at issue, as proposed by the Staff, since the benefits of these costs will be realized in future periods. This holding is consistent with the Commission's determination of this issue in P.S.C. Case No. TR-79-213 and P.S.C. Case No. TR-81-208.

### 3. Summary

Staff's proposed adjustments to the Company's operating expenses related to the License Contract are adopted. As a result, \$3,731,000 of the Company's total test year License Contract expenses are disallowed, and \$5,595,000 of those expenses shall be accorded capitalization treatment. The revenue effect of these determinations is to increase SWB's net operating income by \$4,874,000.

#### B. Business Information Systems (BIS)

Staff proposes to disallow \$12,000 of SWB operating expenses representing expenses incurred for a business information systems (BIS) project which SWB does not plan to utilize. Staff further proposes to defer \$244,000, representing the expenses incurred for BIS projects not currently utilized by Southwestern Bell but which are planned for future implementation. Once a BIS project is implemented, Staff recommends that the cost should be amortized over ten years rather than charged to current expense. The Company opposes Staff's proposed adjustments, both in principle and amount.

In 1967, the BOCs (including Southwestern Bell) entered into an agreement with Bell Labs for the development of specific electronic data processing and business information systems and programs (computer software). Prior to the negotiation of the BIS agreement, the BOCs had been separately engaging in this type of work. However, it was determined that a centralized development effort was needed for the efficient development and design of such systems and programs.

The Staff asserts that no logical explanation has been advanced by the Company as to why the work performed under the BIS agreement was not performed under the License Contract instead. Since the License Contract provides that License Contract payments cannot exceed 2.5 percent of Southwestern Bell's gross revenues, Staff reasons that to the degree that AT&T can transfer services and the associated costs conducted under the BIS agreement outside of the License Contract, this 2.5 percent ceiling can be circumvented. Staff's proposed adjustment, however, is not designed specifically to limit Southwestern Bell to total payments through the License Contract and BIS together, to 2.5 percent of revenues. Rather, it is Staff's specific contention that the Company should not pay for BIS projects which it does not have currently in use or planned for implementation, and should defer on the Company's books (and accrue IDC at the Company's approved cost of capital) the development costs for BIS projects planned for use but not currently implemented.

Centralization of computer software development and design provides access to the technical resources necessary to develop complex data processing and business information systems and programs. The choice of what BIS projects will be undertaken, and the authorization for funding such work, are made by an advisory committee composed of a representative (at the vice president level) from each participating BOC, Long Lines, and Bell Labs. A consensus must prevail before a project is authorized, to assure that only projects with broad general support are funded. Under the terms of the agreement, Bell Labs performs the developmental work, in return for which each BOC which is a party to the agreement annually pays its

fully allocated share of the total developmental costs and receives unrestricted use of any system developed thereby.

Missouri ratepayers have received some \$12,675,000 in developmental value (i.e., benefits derived from sharing the costs for the development of the systems), and some \$23,342,000 in operational value (the benefits derived from the use of the systems), on an intrastate basis during the test year in this case from participation in the BIS agreement. This money represents the amount saved by SWB in sharing the costs of development of BIS systems by Bell Labs through participation in the BIS agreement as opposed to doing the development work itself, and the amount saved by SWB in actually utilizing the BIS systems so developed compared to not using any system or doing the work performed by the system in another way. It is clear that the present funding arrangement under the BIS agreement has provided necessary moneys to investigate a broad range of computer applications which would otherwise not have been possible. It appears likely that if only those companies which use the systems currently used in Missouri paid for those systems, the costs to the Missouri ratepayer would have been higher than the actual Company expenditure under the BIS agreement in the test year. For these reasons, Staff's proposed disallowance of a portion of Company's BIS expenses is rejected.

Further, the Commission is not persuaded that deferral of a portion of those BIS expenses is reasonable. Such a deferral would interrupt the flow in the relationship between the costs and the benefits of BIS projects which has been in effect for many years. The expensing of all BIS costs has existed since implementation of the BIS agreement. The evidence is clear that participation in the BIS agreement benefits Southwestern Bell and its ratepayers to a degree far in excess of the actual annual expenses of SWB under the BIS agreement. Staff's proposed deferral of some of the BIS costs must also be rejected.

Finally, the Commission finds and concludes that the Staff has not shown that its proposed ten-year amortization period for the recovery of BIS development

costs, once systems are actually implemented, bears any relationship to the actual service life of all or any part of a computer system; and that Staff's proposal is not consistent with the Commission's allowance of the contested BIS payments discussed above.

The Staff's proposed adjustments concerning business information systems are rejected.

C. Conduit and Cost Sharing

This issue involves the Company's participation in certain conduit and cost sharing arrangements during the test period. Conduit arrangements involve the centralized purchase of services, where all of the costs represent work done entirely by outside vendors and contractors. The project may be offered by AT&T or another Bell Operating Company, which acts as the managing party and billing agent. Participation in a conduit arrangement is optional, and the bulk costs therefor are prorated to the participating BOCs by the managing party. Examples of conduit arrangements include national advertising and insurance.

Cost sharing projects, on the other hand, involve the specific development, on a centralized basis, of services, products or processes of an operational nature. They are performed under a written agreement entered into by AT&T, Bell Labs and the BOCs for a specific project. Like conduit arrangements, participation therein is optional and the costs of participation are shared by the participating companies. Examples of cost sharing projects are specialized training and marketing programs.

In the instant case, Staff is proposing that \$1,705,800 of the Company's proposed operating expenses should be disallowed to account for conduit and cost sharing projects which: (1) are beneficial to the fully separated subsidiary or FSS being created as a result of the FCC's Decision in Computer Inquiry II; or (2) are related to activities which focus on maintaining or improving AT&T's corporate image. More specifically, Staff proposes to disallow 100 percent (or \$38,800) of the costs associated with sponsorship of the theme pavilions at the Experimental

Prototype Community of Tomorrow (EPCOT), on the basis that any benefit therefrom will flow to the FSS (American Bell, Inc.) and to AT&T. Staff further proposes to disallow 75 percent (or \$556,700) of the costs of AT&T national advertising, and to disallow 50 percent (or \$1,110,300) of the costs associated with a large number of marketing-related projects which Staff believes will benefit unregulated Bell System entities.

The Company opposes Staff's proposed adjustments, except for a \$78,200 amount related to projects reported by AT&T to the FCC under Paragraph 105 of the Computer Inquiry II Order. It is the Company's position that the conduit and cost sharing projects at issue in this case provided substantial benefit to Southwestern Bell and its Missouri ratepayers, both in terms of revenue generation and cost savings, in the test year.

The EPCOT projects are located in Disney World in Florida. Staff contends that Southwestern Bell will derive no benefit from these theme pavilions at EPCOT. Rather, Staff asserts, the only benefits which will be realized as a result of those theme pavilions will accrue to the fully separated subsidiary (American Bell, Inc.), which is being created as a result of the FCC's Decision in Computer Inquiry II, which will provide new CPE and enhanced services after January 1, 1983. The Company did not rebut this contention.

Staff also asserts that AT&T national advertising is primarily geared to Bell System marketing goals to improve the AT&T corporate image and achieve an overall awareness of the Bell System. Staff proposes to disallow 75 percent of these national advertising expenses.

On the other hand, the Company asserts that 77 percent of the AT&T national advertising was promotional in nature, designed to persuade customers to use the Bell System's telecommunications products and services, not merely to improve AT&T's corporate image. In fact, since the advertising was designed to benefit the entire System (including the BOCs who directly offer these products and services), Company

asserts the advertising used the Bell seal and the words "Bell System", rather than any reference to AT&T. The Company asserts that AT&T national advertising serves as a necessary platform for SWB's local advertising; that this AT&T advertising is received by SWB at about 10 percent of its total cost; and that such advertising expenses maintain existing revenues and gain additional revenues by promoting the use of optional, discretionary or competitive products and services.

The last element of this issue is Staff's proposal concerning some 25 projects of a marketing nature which Staff alleges will be beneficial to the FSS and not to Southwestern Bell on a going-forward basis. These projects fall into three categories: multistate marketing, training, and sales and support. Staff acknowledges that Southwestern Bell did receive some benefits from these projects in the test year. As a result, Staff proposes only a 50 percent disallowance of these costs. However, Staff contends that marketing and sales-related projects are prospective in nature, since they establish a favorable environment for product acceptance in the future. The FSS that will begin to market new customer premises equipment (CPE) as of January 1, 1983, will benefit from marketing and sales projects initiated prior to that date. The projects in this proposed 50 percent disallowance category include projects related to marketing of DIMENSION<sup>R</sup> PBX and HORIZON<sup>R</sup> communications systems. These products and other business offerings, Bell's design line sets, and customer calling services will be available through the PhoneCenter stores, and therefore offered by the FSS, after January 1, 1983. After that date, SWB will still be permitted to lease CPE out of existing inventory, and after January 1, 1984, SWB will be permitted to reenter the CPE market with new equipment. However, under the MFJ, current skilled terminal equipment services and sales personnel will be transferred to AT&T.

Company argues that the conduit and cost sharing projects for which Staff recommends 50 percent disallowance were selected for participation by SWB during or before mid-1980, before the Computer Inquiry II Decision of the FCC which required

the establishment of the FSS. Company asserts that the work was undertaken by Southwestern Bell management to support activities related to the Company's operations which existed then and continue to exist currently. In Company's view, the decision of SWB management to participate in these projects was a proper one. SWB alleges that it received the products or services it paid for and that each was used extensively in Missouri for the benefit of SWB operations.

The Commission concludes that the Company has not met its burden of proving that its conduit and cost sharing expenses are just and reasonable, at the levels proposed by the Company. The Commission further concludes that Staff's proposed adjustment to operating expenses related to conduit and cost sharing projects should be adopted.

D. Western Electric Profits

Southwestern Bell, like other telephone companies in the Bell System, purchases products and services from Western Electric Company, which is also 100 percent owned by AT&T. In this case, Staff proposes that the Company's intrastate operating expenses should be reduced by \$1,478,000 to adjust for allegedly excess prices paid by Southwestern Bell to Western Electric for Western products which resulted in excessive profits for Western Electric during the past five years.

In 1981, Western Electric had \$12,109,000,000 in sales to Bell BOCs. In the same year, Western's sales outside of the Bell System were \$496,000,000. Excluding sales to government, those non-System sales totaled \$356,000,000. The evidence indicates that some 30 to 40 percent of Western's sales are of products for which no comparable substitute product is available from another supplier.

Staff also proposes that the Company's intrastate rate base be reduced by \$1,529,000 to account for these alleged excess profits of Western Electric Company. That proposed adjustment is addressed hereinbelow in Section V.D.

The Bell System Purchased Products Division (BSPPD) performs price comparison studies (PCS) on a quarterly basis for each Bell Operating Company (BOC),

the results of which are provided to the BOCs as an input to their procurement process and as evidence of the reasonableness of Western Electric prices for use in regulatory proceedings. The PCS groups telecommunications products into the categories of telephone apparatus, cable, telecommunications supplies, transmission equipment and switching equipment. Surveys are then conducted which are intended to identify equivalent general trade products. Company asserts that telecommunications products and services are included in the PCS if commercially available general trade products and services performing the same function as the Western Electric products and services can be found, adequate price and quantity information are available, and annual Western Electric sales of the individual product to BOCs were at least \$100,000. Once equivalent general trade products and services are identified, the suppliers of those products are asked to provide their lowest price to the BOCs, based upon what they determine to be their optimum volumes for direct sales to the BOCs. Maximum discounts are sought, and only the lowest price is used in the PCS. Having determined the lowest priced general trade product, a percentage relationship is developed for each category of product and on an overall basis. The results of the PCS presented in this case by Southwestern Bell indicate that the prices charged by Western Electric for telecommunications products and services in Missouri are, overall, 86 percent of the lowest prices charged by the general trade suppliers of telecommunications products and services which perform the same function.

The Company also conducted a comparative risk analysis of Western's sales and earnings on its Bell business, which analyzed Western's business and financial risks vis-a-vis that of the 50 Largest Manufacturers listed in the May 1982 issue of Fortune Magazine (excluding Western Electric, petroleum and mining companies) and the Standard & Poor's (S&P) 400 Industrials (excluding AT&T) for the periods 1960 through 1981, and 1972 through 1981. The Company's witness analyzed the impact of changes in Bell System operating revenues and construction expenditures, Western Electric's affiliation with the Bell System, forecasts from the BOCs, the impact of

innovation and of research and systems engineering on Western's prices, and the financial characteristics of Western Electric. According to the Company, these analyses reflect that Western's business and financial risks have been similar to those of other manufacturers. Company's witness also studied the volatility of Western Electric's sales and earnings, and Western's rate of return on investment and equity vis-a-vis the two composites. It was his testimony that for both the period 1960 through 1981 and 1972 through 1981, Western Electric has received an average return on net investment and equity which is lower than that received by Fortune's 50 Largest Manufacturers and the S&P 400 Industrials.

Staff is critical of the Company's PCS as well as Company's comparative risk analysis. Staff is critical of the Company PCS because it neither covered the entire universe of products nor employed probability sampling to select the products covered; because services are not considered; because the equivalency standards of the PCS were inadequate in that the general trade supplier prices used on the PCS are inaccurate; and because Western's prices exclude relevant costs. Staff avers that general trade manufacturers have difficulty properly preparing discounted prices for Bell's high quantity purchases because of the lack of history of past Bell non-Western purchases, the lack of any purchasing authority of the BSPPD compiling the PCS, and the unlikelihood of successfully selling to the Bell System. Staff also contends that Western's prices exclude: the costs of basic research (Research and Systems Engineering, or R&SE) performed by Bell Laboratories related to Western products; the costs of services received from AT&T; bad debt expense from BOC business; and the costs of traditional sales and marketing efforts.

The Company points out that the PCS included nearly 60 percent of the BOCs' total purchases from Western Electric, including a full range of technology and manufacturing processes, prices from a few pennies to hundreds of thousands of dollars and products with purchases from \$100,000 to in excess of \$1 billion. Further, probability sampling would not address the entire universe of products or

services, as Staff prefers; and the accuracy of the PCS itself is, in fact, verified by a randomly generated statistical sample.

In addition, Western Electric engineering and installation services are included in the central office switching system study, and BSPPD has done price comparisons of Western's repair service's prices which reflect them to be, overall, 71 percent of the lowest obtained from the general trade. Thus, certain services have been considered in the PCS. Concerning the equivalency standards of the PCS, the equivalency of general trade products is determined by establishing that a Western Electric product, and a general trade product, perform the same function in terms of use, feature and technology. Company asserts that the goal of the PCS to identify all general trade products capable of performing a similar function to the Western Electric product, and to cover the maximum number of alternative products possible, could not reasonably be met if Western went on to perform an evaluation of mechanical interchangeability, layout and quality as proposed by the Staff witness.

Concerning the prices used in the study, Southwestern Bell does not contend that the PCS is the sole basis upon which a purchasing decision is made. In fact, the Company's witness testified that the PCS is but one input to that process, and that many other factors must also be considered by the BOCs when evaluating products for purchase. The other purpose of the PCS is to show regulatory agencies the reasonableness of the prices paid by Southwestern Bell to Western Electric, by attempting to demonstrate that if Southwestern Bell were to purchase the lowest priced general trade telecommunications products and services instead of Western Electric's, the Company would, overall, pay significantly more for those equivalent products and services.

Staff's witness performed his own comparative risk analysis of Western Electric vis-a-vis Fortune's 50 Largest Manufacturers and Moody's 125 Industrials, but only for the period 1977 through 1981. Staff's witness concluded that Western Electric has lower overall risk vis-a-vis the two composites used by Staff. Staff's

witness further concluded that Western Electric has earned more on net investment during the five-year study period than the average of a composite of 30 companies taken from Moody's 125 Industrials (15 of which had greater than, and 15 of which had less than, Western's index of sales volatility).

The comparative risk analysis performed by the Staff relies on data limited to the most recent five-year period, 1977 to 1981. Staff asserts that this period was chosen in order to show Western Electric in a current light. Staff asserts that the 1975-1976 period was atypical and transitional in nature and that a new, higher-earning and more productive Western Electric Company existed after that transition period. Staff points out that the study period it selected does include the recession of 1980.

Company is critical of the 1977 to 1981 period selected for comparison by the Staff, pointing out, inter alia, that the Staff's approach is inconsistent with that of Staff's rate of return witness in this case, who consistently utilized a ten-year period (1972 to 1981) in his analysis of SWB's rate of return on its total Company operations. (See Section VII, below). The Company asserts that, had Staff used either a 20-year period or a ten-year period in its analysis, Western Electric's earnings would have been reasonable vis-a-vis any comparable risk composite. Only by limiting its analysis to five of the most profitable years, and by ignoring two of the most unprofitable years (1974-1975) in Western Electric's history, was Staff's witness able to conclude that Western Electric is overearning, in Company's view. Company avers that its comparative earnings analysis covers a period which includes major peaks and troughs in the national economy.

Staff's witness supported his selection of a comparable risk composite by showing percentage changes in return between Western and the witness' selected companies over the five-year period 1977 to 1981. Company argues that the arbitrary nature of this approach can be seen by a change in the number of companies selected by using a weighted average. Had Staff's witness used 20 companies rather

than 30 companies and had he used a weighted average, the 1981 return on investment for those companies would have been 15.9 percent, as compared to the 11.1 percent calculated by Staff's witness. Western's 1981 return on investment was 14.3 percent. Company asserts that this degree of difference in the percentage return on investment demonstrates the inherent bias and extreme selectivity employed by Staff's witness in developing his comparative risk composite.

Company asserts that volatility of earnings is a significant indicator of business risk, since it most nearly incorporates the effects of all the factors which affect a firm's business risk. Company's analysis compared Western Electric's volatility of earnings on its Bell business with the median of both Fortune's 50 Largest Manufacturers and S&P's 400 Industrials. This analysis showed that for the period 1960 to 1981, Western's volatility of earnings has been greater than the median of either of the two groups compared.

The Company is critical of Staff's comparable earnings analysis because it ignores volatility of earnings and because Staff's witness based his conclusions on the single factor of demand risk exhibited by sales variability or volatility. Company asserts that this is only one of a number of factors which influence business risk. Company asserts that Staff's witness has failed to perform any comprehensive business risk analysis; that Staff's witness' dismissal of Western Electric's drop in earnings during the 1974-1975 recession as "atypical" (when 16 out of the 26 companies in his own comparative risk composite suffered earnings declines in 1974-1975) is inconsistent and unsubstantiated.

The Company may or may not have paid excessive prices to Western. Staff has raised serious and legitimate questions as to the validity of the Company's PCS. The Commission notes the lack of evidence as to SWB's actual procurement policies and as to any competitive bidding process which SWB may use to determine whether a Western product should be purchased rather than a comparable product of another manufacturer.

While the issue should be further investigated in the future, the Commission cannot conclude on the record before it that Staff's comparative risk analysis can be relied upon or that Company's PCS must be rejected in this case.

For these reasons, the Commission finds and concludes that the Staff's proposed adjustment to net operating income in this case based upon allegedly excessive Western Electric profits should be rejected. However, the Company should be aware of its burden in future cases to demonstrate affirmatively in a comprehensive manner the reasonableness of the prices paid to Western. The Staff and other parties should fully investigate the Company's information and analysis and, if warranted, again present the question to the Commission.

E. Discounted Telephone Service

Public Counsel proposes to increase the Company's test year operating revenues by \$3,294,000 in recognition of revenues foregone by the Company as a result of providing telephone service to employees at discounts from tariffed rates or free of charge. The Company disputes both the amount of Public Counsel's proposed adjustment and its propriety. No other party took a position on this issue.

Public Counsel's proposed adjustment was calculated by first determining the average revenue to the Company per residential customer (\$372.09). That figure was then multiplied by 11,167 nonmanagement level employees of the Company, times 50 percent (representing the percentage of telephone service discount applicable to nonmanagement employees); and then multiplied by the number of management level employees (3,269), who receive a 100 percent discount. Public Counsel also asserts that the Company's wage scale is very competitive, so that the discounted telephone service benefit is not necessary to attract and retain qualified employees. Public Counsel submitted an exhibit purporting to compare seven Company job classifications with seven State of Missouri employee job classifications as to entry level wages, and wages after 42 months of service.

Public Counsel's calculation is erroneous insofar as the average residential revenue figure of \$372.09 includes both interstate and intrastate revenues, and includes miscellaneous revenues which are not subject to employee discounts. Nonmanagement employees do not receive a discount on personal toll charges except in the case of emergencies or while working away from home overnight. Company adjusted Public Counsel's calculation for these errors and determined that the actual calculation, using Public Counsel's methodology (which Company does not concede is correct) should have been \$1,777,000. Company further maintains, however, that the actual amount of discounted employee telephone service is not identifiable, so that any amount attributed to the employee discount would be totally speculative.

The Commission cannot accept Public Counsel's proposed adjustment for discounted telephone service. Public Counsel has not proven that the Company's wage scale is already so competitive that the discounted telephone service benefit is not necessary to attract and retain qualified employees. Public Counsel's comparison of certain Southwestern Bell jobs with certain State of Missouri jobs showed that, although all seven of the Company positions included in the study had greater financial advancement after 42 months of employment, the Company offered lower entry level wages for four of the seven positions studied. Further, not all of the Southwestern Bell positions utilized in the study were entry level positions, and the record does not conclusively demonstrate that the job descriptions of the positions compared were in fact comparable.

Furthermore, the Commission finds that any savings realized from the elimination or reduction of the discounted telephone service benefit is likely to be more than offset by higher wages. The provision of such employee discounts over the past 63 years has become a custom and practice which, under federal labor law, may now be binding on the Company. Were the discounts reduced or eliminated, that change would have to be negotiated by the Company with the union. Equivalent cash compensation would cost Southwestern Bell \$1.68 for each dollar's worth of discounted

telephone service provided to nonmanagement employees, because of the effect of additional Social Security taxes, pension and other benefit payments.

For these reasons, the Commission determines that Public Counsel's proposed adjustment should not be approved. Since the adjustment is being disapproved on the grounds stated above, it is not necessary for the Commission to address Public Counsel's interpretation of Section 392.220, R.S.Mo. 1978.

F. Test Year Uncollectibles

Company and Staff agree that a positive relationship exists between bad debt write-offs and revenues, and that a ratio of test year bad debt write-offs to test year revenues should be multiplied by annualized revenues to determine an appropriate amount of uncollectibles as of the end of the test year in this case. Company and Staff differ only on the appropriate ratio. Staff's proposed ratio (.6418 percent) is derived by taking a simple average of test year write-offs to test year revenues, and results in \$5,595,000 in test year uncollectibles. Company's proposed ratio (.7000 percent) is derived by a simple weighting technique which assigns more importance to the last months of the test year than the first months. Instead of giving equal weight to each month of the test year as does the Staff, Company assigns a weight of 1 to the first month, a weight of 2 to the second month, and so forth, up to 12 for the last month of the test year. Company asserts that its weighting methodology provides a more accurate end-of-test-year level than does the Staff's method. The weighted months' write-offs and revenues are then averaged to produce Company's ratio. Company's method yields \$6,102,000 in test year uncollectibles.

Public Counsel asserts that no positive relationship exists between bad debt write-offs and revenues. Public Counsel proposes to use actual test year bad debt write-offs as the appropriate end-of-period level of uncollectibles. The Public Counsel's method results in test year uncollectibles of \$5,017,000.

The Commission finds that a positive relationship does exist between bad debt write-offs and revenues. As a result, Public Counsel's proposed methodology for the calculation of test year uncollectibles must be rejected.

The Commission further finds that the Staff's methodology for calculating the ratio to be applied to annualized revenues is more accurate than Company's methodology. Company has not met its burden of proving the reasonableness of the numerical levels of the weights applied in Company's weighting procedure. Further, adoption of Company's weighting method would require the Company to prove that the data shows no seasonal fluctuations. The Company has not met its burden of proving such fact.

The Commission finds that .6418 percent is the appropriate ratio of test year bad debt write-offs to test year revenues to be applied to annualized revenues in this case for determination of test year uncollectibles.

G. Operating Uncollectible Revenues Gross-up

The Company proposes to apply its uncollectible ratio factor to any additional revenues granted as a result of the instant case, in order to provide for additional uncollectibles resulting from increased rates. Staff and Public Counsel oppose inclusion of such an operating uncollectible "gross-up".

Company asserts that the uncollectible gross-up merely adds a measurable change to the test year data, i.e., the amount of increased revenues the Company will expect during the time the new rates will be in effect. Company avers that it is totally inconsistent for Staff not to at least recommend its .6418 ratio as the appropriate uncollectible gross-up ratio. Public Counsel, on the other hand, asserts that it is not enough that uncollectibles and revenues tend in the long run to move in the same direction, but that Company's proposed uncollectible gross-up is based on the proposition that each additional dollar of revenue collected by the Company must generate the same amount of additional uncollectibles as did each previous dollar, on average. Public Counsel asserts that there is no evidence in the record to support such a conclusion.

Staff distinguishes its opposition to the proposed uncollectible gross-up from its position concerning test year uncollectibles (see Section IV.F, supra), on the basis that "annualization" deals with measurable changes related to the actual test year, while the gross-up applies to changes predicted for the period over which the rates will go into effect. Since the ratio of bad debts to revenues is an empirical relationship which must be estimated, Staff is only willing to use that ratio in the calculation of historical test year uncollectibles using a methodology which annualizes uncollectibles using historical data. Staff asserts that this methodology is only relevant to what will happen in the future under the assumption that no known or measurable changes will take place in the future. Staff avers that the Company has not met its burden of proving that the ratio of uncollectibles to revenues will not be lower or higher during the period in which the rates set in this case will be in effect. It is Staff's position that the Company has not quantified all factors which may affect uncollectibles in the future.

That a positive relationship exists between bad debt write-offs and revenues is the underlying premise on which the cases of both the Company and the Staff concerning test year uncollectibles are based. That premise has been accepted by the Commission hereinabove (see Section IV.F). Company does not propose to apply an uncollectible ratio to some purely forecasted or projected revenue figure in the future. Rather, the Company's proposed "gross-up" would merely assure that the ratio of uncollectibles to revenues approved hereinabove by the Commission would be applied to any additional revenue requirement approved by the Commission in this case. The Commission finds the Company's proposed uncollectibles gross-up to be reasonable. However, the percentage to be applied for the calculation of such an uncollectible gross-up will be the Staff's uncollectible ratio (.6418 percent), as approved by the Commission at Section IV.F.

H. Loaned Employees/United Way

Public Counsel proposes to disallow \$19,016 in salary expense representing the portion of the salaries of six Southwestern Bell management employees who were "loaned" to the United Way of Greater St. Louis for 49 days during the test year. The Company opposes Public Counsel's proposed adjustment. Staff participated in the hearing of the issue, but took no position on the merits.

United Way's "Loaned Executive Program" involves the assignment of selected individuals from business organizations, labor unions, government and educational facilities to work full time in the United Way Campaign. The program has been utilized in the St. Louis United Way Campaign for the past 25 years, and currently involves a total of some 150 "loaned executives" from 79 businesses or other organizations. Each "loaned executive" is assigned a certain number of "accounts", which are businesses or other organizations. The loaned executives work with each of their accounts in attempting to organize and carry out a United Way fund raising campaign within the account-organization.

The six Southwestern Bell Telephone Company employees in question were responsible for 218 accounts which contributed nearly \$530,000 to the 1981 United Way of Greater St. Louis Campaign. The total campaign produced over \$23,000,000 in 1981, and benefits were received by some 900,000 St. Louis area residents.

The Southwestern Bell management employees participating in the loaned executive program essentially worked full time on behalf of the United Way organization during the 10-week period in the test year. They received their full salaries and benefits from the Company during that period of time. Public Counsel asserts that the salaries and benefits associated with the loaned executive program represent a charitable contribution which should be disallowed in conformance with Commission precedents. In Re: Gas Service Company, Mo. P.S.C. Case No. GR-81-155, at pages 25-26, the Commission disallowed charitable contributions as operating expenses because: (1) their inclusion in rates would result in involuntary ratepayer

contributions to the particular charity; (2) they provide no benefit to ratepayers; and (3) they are not necessary for the provision of safe and adequate service.

Company asserts, however, that the loaned executive program does not increase rates, since no additional salaries or wages are paid during the fund raising drive in order to replace the management employees who are assigned to the loaned executive program. According to Company's testimony, the "loaned executives" do come into the Southwestern Bell office after hours as necessary to ensure complete coverage of their Company responsibilities, and the loaned employees' co-workers also contribute extra efforts to ensure coverage of the loaned employees' responsibilities. Southwestern Bell alleges that since there is no additional cost or burden placed upon the ratepayers as a result of the loaned employee program, either in terms of extra monetary expense or in terms of reduced job efficiency, the traditional charitable contribution standard should not be applied by the Commission.

The Company also asserts that the Company, and therefore its ratepayers, receive several benefits from participation in the loaned employee program. Since more than 90 percent of Missouri residents have telephone service, the Company asserts that it is reasonable to assume that the United Way Program benefits a number of Missouri citizens who are also ratepayers. Secondly, says the Company, the loaned employees benefit from the interpersonal relationships experienced with members of the community they serve while working with the United Way, gaining valuable experience which can be translated back to their SWB jobs. The Company believes that its ex-loaned executives are more effective in handling their daily job responsibilities, with particularly strong development in their dealings with customers and in their interpersonal relationships. Third, Company asserts that the community receives benefits from United Way programs such as day-care centers, health and welfare agencies, and others, and that, to the extent that the community is enhanced by such programs, Southwestern Bell is also enhanced. This is true, it

is asserted, not only because Southwestern Bell has an investment in the community, but also because the community is more likely to attract and retain potential customers.

Public Counsel asserts that the Company's argument that the loaned executive program imposes no additional cost on ratepayers is irrelevant to a determination of the issue. The issue, according to Public Counsel, is whether ratepayers should be required to pay, through rates, the salaries and benefits of employees participating in the United Way fund raising campaign on essentially a full-time basis for a 10-week period, rather than devoting their full-time efforts to the safe and adequate provision of utility service. Public Counsel asserts that if it is true that the Company's overall efficiency has not been affected by its participation in the program, a question must be raised whether a permanent reduction in the Company's executive work force is not warranted.

The issue before the Commission is not whether the United Way Campaign is worthwhile. Governmental agencies of the State of Missouri, including this Commission, participate in the United Way drive, as does Southwestern Bell Telephone Company. The issue before the Commission is simply whether the \$19,016 of salary expense for the Southwestern Bell management employees who participated in the United Way's "Loaned Executive Program" should be allowed in Company's rates. While some assistance is received by some individual ratepayers of Southwestern Bell from the United Way Campaign, that fact is not dispositive of the issue. Such assistance is distributed unevenly among those ratepayers and is not related to their status as ratepayers. Nor can the Commission find, upon the record herein, that the general enhancement of the community resulting from the St. Louis United Way drive generally benefits SWB's ratepayers.

The Company also believes that the Loaned Executive Program improves the managerial effectiveness of the SWB employees who participate in the program. That belief has not been empirically verified upon the record of this case, however.

While the Commission is willing to entertain the possibility that SWB's participation in the Loaned Executive Program could benefit the Company's ratepayers, the Commission finds, on the record before it, that the Company has not met its burden of proving in this case that such participation does benefit those ratepayers.

Public Counsel's proposed adjustment is approved. Southwestern Bell's test year expense in this case shall be reduced by \$19,016.

I. Capitalized Property Taxes

The Company proposes to expense property taxes associated with telephone plant under construction (TPUC), plant booked directly to Plant in Service and materials and supplies. Staff proposes that such property taxes be capitalized, and also be used as a current income tax deduction in the calculation of income taxes. The revenue requirement effect of Staff's proposal is \$1,093,000. The issue can be addressed in two subparts.

1. Materials and Supplies (M&S)

Staff proposes the capitalization of property taxes related to materials and supplies (M&S) which Staff attributes to construction, although not proposing to disallow any portion of M&S from the Company's rate base. Staff allocates these taxes to construction based upon the relationship of M&S charges to construction or Plant in Service during the test period. Company argues that M&S balances are supportive of the property and equipment which is necessary to maintain daily service to its customers. The Company further avers that specific identification of materials which are used in construction is not possible since the same items may be used in either construction or maintenance. The Commission agrees with the Company on this subissue, and rejects the Staff's proposal. The Commission's finding is consistent with that in Re: Kansas City Power & Light Company, Case No. ER-82-66 (1982).

## 2. TPUC, and Plant Booked Directly to Plant in Service

Staff also proposes to capitalize property taxes related to telephone plant under construction (TPUC) and plant booked directly to plant in service (Account No. 100.1). Staff also proposes to disallow both of these items from the Company's rate base in this case. (See Sections V.A and V.B, below). The Company opposes capitalization of property taxes related to these items unless those taxes can be identified with specific construction projects. Company asserts that its position is supported by the Uniform System of Accounts and is the basis upon which the Company capitalizes property taxes on its books of account. The FCC specifically provides for the capitalization of taxes on physical property at Paragraph 31.2-22 B (8) of the Uniform System of Accounts as follows:

Taxes ... on physical property during construction and before the facilities are completed and ready for service which are assessed separately from taxes on operating property or under conditions which permit separate identification or allocation of the amount chargeable to construction. [Emphases added].

The Company follows the separate identification procedure in its books and records, and regularly capitalizes identifiable property taxes. The Company argues that Staff's approach results in the allocation of taxes to construction projects which never incurred any property taxes while under construction.

The Commission cannot find that the Company's interpretation of the Uniform System of Accounts is not reasonable nor that the Staff's interpretation is more reasonable, based upon this record. Therefore, property taxes related to TPUC and to plant booked directly to plant in service should be expensed, and not capitalized, except where such taxes are assessed separately from taxes on operating property or where conditions permit separate identification or allocation of the amount chargeable to construction, within the provisions of the Uniform System of Accounts.

Company's proposal is adopted.

J. Rate Case Expenses

Public Counsel proposes that the Company be required, on a prospective basis, to segregate all of its expenses associated with Missouri intrastate rate case proceedings, including: (a) fees paid to outside consultants; (b) expenses associated with the participation of in-house Company personnel in rate proceedings, including the proportional amount of salaries or wages paid to such employees during their preparation for and participation in the proceedings; and (c) miscellaneous costs. Public Counsel further proposes that, should the Commission find little or no revenue deficiency in the instant case, all known rate case expenses associated with this proceeding be disallowed. The Company opposes both proposals. No other party addressed the issue.

Company's objection to Public Counsel's record keeping proposal does not go to those expenses which Company considers readily identifiable, such as the portion of expenses relating to outside consultants. Company states that it has, in fact, provided that information in response to Public Counsel data requests, and has provided Public Counsel with estimates of miscellaneous expenses such as copying and materials. Company asserts, however, that segregating the expenses associated with the participation of Company personnel in rate case proceedings stands on a different footing. On cross-examination, the Company's policy witness stated that it would be impossible to segregate rate case expenses because the same Company personnel worked on both rate case activities and other job responsibilities. Public Counsel responds that Company's argument is really one of burdensomeness, not impossibility. Public Counsel believes that Company employees could keep time sheets relating to work activity, as do private attorneys and people in many other businesses. Public Counsel observes that if additional administrative costs are incurred by the Company in order to maintain time allocation records, they will eventually be borne by ratepayers as legitimate business expenses of the Company. Without such time allocation records, however, Public Counsel asserts that it is impossible for the Commission to determine the reasonableness of Company's rate case expenses.

The Commission agrees with the Public Counsel that in order for the Commission to determine the reasonableness of the level of rate case expenses proposed to be included in Southwestern Bell's Missouri intrastate rates, the Company must be required to keep accurate and detailed records of those expenses. The Commission will order Southwestern Bell Telephone Company to hereafter segregate all of its expenses associated with Missouri intrastate rate case proceedings, in accordance with Public Counsel's proposal.

As to Public Counsel's second proposal, there is no evidence before the Commission in this case indicating bad faith on the part of the Company in filing and prosecuting the instant rate case. Therefore, the known rate case expenses associated with the instant proceeding will not be disallowed.

K. Income Taxes

1. Interest Expense

The Staff proposes to use in its income tax calculation, \$79,844,000 of interest expense. The Company contends that \$64,227,000 is the correct amount. Thus, the revenue requirement value of the difference between the alleged interest amounts is \$14,267,000.

The major differences between the proposals of Staff and Company concerning the appropriate level of interest expense to be used as a deduction in income tax calculations relate to three factors, set out separately below.

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

The Staff proposes to flow through interest related to telephone plant under construction (TPUC). The Company proposes that interest related to short-term TPUC not be used in its income tax calculation unless short-term TPUC is included in rate base. The Company proposes that interest related to long-term TPUC not be used in its interest expense for income tax purposes.

The Company's contention on this issue is that current recognition of the interest-related tax benefit and deferred rate base inclusion of the corresponding

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

The Commission is of the opinion that the question of the appropriate ratemaking treatment to be accorded the tax timing treatment of interest related to TPUC is equivalent in nature to other normalization versus flow-through issues. Inasmuch as the Commission has determined that the tax timing differences at issue in this case should be accorded flow-through treatment (see Section IV.K.2, below), the Commission finds and concludes that the benefit of the Company's tax deduction resulting from interest related to TPUC (both short- and long-term) should be flowed through currently to ratepayers. As a result of the Commission's determination on this issue, the Company's proposed net operating income for ratemaking purposes should be increased by \$1,006,000.

b. Interest Related to Job Development Investment Tax Credits (JDITC)

The Job Development Investment Tax Credit (JDITC), enacted by Congress in 1971, provides for a federal income tax forgiveness of 10 percent of the amount of all qualified investments. In calculating the Staff's proposed deduction for interest expense in this case, Staff computed annualized interest by applying the total Company weighted cost of debt to the Staff's adjusted rate base inclusive of

rate base financed by JDITC. The total Company weighted cost of debt used by the Staff was 4.72 percent based on a total Company double-leveraged debt ratio of 50.14 percent at an embedded cost of 9.41 percent.

The Company asserts that its rate base should be reduced by the amount of JDITC which supports that investment before the weighted cost of debt is applied to rate base to determine the interest expense deduction. Company avers that the telephone plant financed by the funds provided through the JDITC has no interest cost associated with it since the Company does not have to borrow in order to finance this portion of its plant. Company alleges that Staff's attribution of interest associated with plant financed by JDITC is purely hypothetical in nature and should not be utilized in the income tax calculation.

Staff counters that its JDITC interest calculation is no more hypothetical than the return which the Company earns on JDITC. Rather, Staff's methodology uses the interest expense paid by the ratepayer through the rate of return on rate base as the interest deduction in the tax computation. Staff believes that any other methodology would cause a distortion between the interest used in the tax computation and the rate of return calculation.

The Commission finds and concludes that the Staff's proposed use of interest related to the JDITC is appropriate. The Company's ratepayers pay a return on plant supported by JDITC. The use of such plant in the computation of annualized interest for purposes of calculating the Company's interest expense deduction provides for the sharing of the benefits of the JDITC between the Company and the ratepayers. This determination is consistent with the Commission's previous decisions on this issue. Re: Kansas City Power & Light Company, Case No. ER-80-48 (1980); Re: Missouri Public Service Company, Case Nos. GR-80-117 and ER-80-118 (1980). It is also consistent with the holding of the United States Court of Appeals for the 8th Circuit in Union Electric v. Federal Energy Regulatory Commission, 668 F.2d 389 (8th Cir. 1981).

Staff's position is adopted.

c. Interest Related to Intrastate Capital Structure

The Staff proposes to adjust the Company's total cost of capital in this case to account for varying return requirements of the Company's allegedly different lines of business and its Missouri intrastate rate base. This proposal is discussed in Section VII.B, "Intrastate Rate of Return".

The Staff's proposal on the intrastate rate of return issue would assign a higher level of debt to the Missouri intrastate operations of the Company. As a result, Staff has included an additional interest deduction in its income tax calculations in this case representing the higher level of debt which the Staff believes supports the intrastate portion of the Company's operations.

Since the Commission has determined that the intrastate rate of return proposed by the Staff should not be utilized in this case, (Section VII.B, below), the Staff's proposal to include these additional imputed interest costs in the income tax calculation would be inappropriate.

Staff's proposal is rejected.

2. Normalization Versus Flow-through

The Company proposes to normalize \$1,543,000 in net income requirement associated with tax timing differences related to the Company's vacation costs, and \$3,709,000 in net income requirement associated with salvage and cost of removal tax timing differences. The Internal Revenue Code provides that the company may take as a current tax deduction its anticipated vacation costs for the following year, even though the books reflect only the current year's vacation costs. The salvage and cost of removal tax timing differences are created by including those items in the depreciation rate for book purposes and in recognizing them when incurred for tax purposes.

Staff proposes flow-through treatment of these tax timing differences, except to the extent that Staff and Company have agreed, for purposes of this case,

that the tax timing differences of cost of removal and salvage resulting from telephone plant placed by Company after December 31, 1980, should be normalized pending an IRS ruling as to whether normalization of those differences is required by the Internal Revenue Code. It is Staff's position that tax timing differences which are not required by the Internal Revenue Code to be normalized should be flowed through. When flow-through treatment is accorded to tax timing differences, the accelerated tax benefit currently realized by the company is currently reflected in rates as a decrease in the company's tax expense. Staff asserts that normalization of the tax timing differences at issue is not necessary for this company, because SWB is not experiencing significant cash flow problems.

The Commission has consistently utilized a "cash flow test" for determining whether normalization treatment should be authorized for particular utilities. Re: Missouri Public Service Company, P.S.C. Case No. 18,502E (1976). See also Re: Southwestern Bell Telephone Company, P.S.C. Case No. TR-81-208 (1981). In analyzing the adequacy of a utility's cash flow, the Commission primarily considers two factors: (1) the company's internally generated funds as a percentage of construction expenditures, and (2) the company's interest coverage.

For the period 1974 through 1981, funds generated internally as a percent of construction expenditures have averaged approximately 54 percent for Southwestern Bell. For the twelve months ended April 30, 1982, the level of funds generated internally as a percent of construction expenditures was 57.68 percent; and for the year 1981, that figure was 66.73 percent. The Company has maintained a AAA bond rating since prior to 1970, and continues to maintain that rating. For the twelve months ended April 30, 1982, the Company's post-tax interest coverage was 2.82 times, and its pretax interest coverage was 4.05 times. For the year 1981, those figures were 2.82 times and 4.03 times, respectively. Southwestern Bell has no interest coverage restrictions in connection with long-term debt issuances. The Company has presented no evidence or argument that it is experiencing cash flow shortages or has limited its construction outlays as the result of cash flow restrictions.

Upon the record herein, the Commission finds and concludes that the tax timing differences at issue in this case should be accorded flow-through treatment, as proposed by the Staff.

The Commission takes official notice that a number of suggestions have been filed in P.S.C. Case No. 00-82-277 ("In the matter of the inquiry into certain matters of concern to the Commission") urging the Commission to reconsider its traditional "cash flow test" for determining normalization versus flow-through issues. In addition, the Company has raised serious questions as to the continued viability of the Commission's longstanding policy on the normalization versus flow-through issue. The Company argues that normalization matches the ultimate income tax effect with the related item of income or expense, and records both in the same accounting time period. The Company submits that flow-through accounting disregards the timing recognition in earnings of the revenue and expense elements giving rise to the tax expense. Since normalization more properly matches the critical elements of the Company's operation, the Company asserts that it also provides a much more accurate depiction of the Company's operation for the use of analysts, investors and regulators. Company also alleges that normalization is the more appropriate accounting treatment of tax timing differences, is consistent with the Uniform System of Accounts and with the treatment accorded these items by the Federal Communications Commission and the Federal Energy Regulatory Commission, and is consistent with the practice of most unregulated firms. In addition, deferred taxes are an important source of internally generated funds which are used by the Company to reduce the cost of financing its construction program.

The Commission is of the opinion that this issue should be made the subject of a generic proceeding in which all interested parties can have an opportunity to present evidence and argument as to why the Commission should, or should not, change its policy regarding the flow-through of tax timing differences. Such a proceeding

will be instituted hereinbelow. However, the Commission is not persuaded upon the record of this case that its cash flow test should not be applied here.

For purposes of the instant case, Staff's proposal is adopted.

V. Rate Base

A. Short-term Telephone Plant Under Construction (TPUC)

The Company proposes to include in its rate base its short-term telephone plant under construction (TPUC) at its September 30, 1982, level (close of trued-up test year) which was \$22,063,000. Short-term TPUC includes those projects which are scheduled for completion in a period of one year or less. The Company asserts that its proposal accurately balances the responsibility of its customers of supporting a construction program, and allows the Company to maintain its books and records for the State of Missouri in accordance with the Uniform System of Accounts prescribed by the FCC without the need for records to support differences between the interstate and intrastate jurisdictions. Based on a 1981 average dollar turnover, SWB's short-term TPUC account turns over 3.2 times per year, or every 3.8 months.

Staff and Public Counsel assert that all TPUC is comparable to construction work in progress (CWIP) and should be excluded from rate base. In Staff's opinion, current ratepayers should not be required to pay rates based on the cost of projects still under construction which will benefit future ratepayers. Staff proposes to allow capitalization of interest during construction (IDC) on TPUC.

The Staff and Public Counsel argue that the inclusion of short-term TPUC in rate base would violate the principle of matching revenues, expenses and investment, since those additional revenues and incremental expense savings which the Company will allegedly realize at some point in time after the plant is placed in service would not also be included within the test period.

In its brief, the Company acknowledges that "in the abstract, Staff's position as to this issue has merit." However, the Company asserts that the

"matching" argument presented by Staff and Public Counsel would hold the Company to an unattainable standard of proof, since the alleged increased revenues or incremental expense savings associated with short-term TPUC cannot be reasonably quantified. Company asserts that the FCC's distinction between short-term and long-term TPUC, and the allowance of short-term TPUC in rates, is a "surrogate" for the strict matching principle. Company submits that this distinction properly balances the interests of all parties and results in a fair and reasonable allocation of costs.

The Commission finds and concludes that it would be inappropriate to include short-term TPUC in rate base in this case, because it would violate the matching of revenues, expenses and plant in the historical test year upon which this case has been presented. The inclusion of short-term TPUC in rate base could only be considered, in the Commission's opinion, in the context of a rate case in which the Commission was presented with forward-looking data carefully designed to maintain a proper match of revenues, expenses and plant.

The Commission is urging the development of new methodologies such as forward-looking data for consideration in the Company's next rate case (see Section XVII, "Test Years in Future Rate Cases"). Upon the record of this case, however, the Commission concludes that short-term TPUC should continue to be excluded from rate base.

The Commission determines that the Company's proposal to include short-term TPUC in rate base in this case should be rejected.

B. Plant Booked Directly to Plant in Service (Account No. 100.1)

The Staff proposes to remove from rate base, and treat as construction work in progress (CWIP), projects under construction costing less than \$25,000 or taking less than two months to complete. Company presently charges such projects directly to Plant in Service (Account No. 100.1). Staff also proposes adjustments to depreciation expense and reserve accounts to eliminate these items, and proposes to

capitalize the associated interest during construction (IDC). Staff's proposed adjustment would reduce the Company's rate base by \$3,978,000.

It is Staff's position that the projects in question will only benefit future ratepayers, and should not be included in the calculation of current rates. Only plant which is actually in service and is used and useful in providing utility service should be included in rate base, in Staff's view.

Company contends that it is keeping its books relative to these items in strict conformance with the Uniform System of Accounts, and asserts that this treatment of these projects is designed to eliminate the need to incur the additional costs of maintaining records to account for these relatively low-cost projects, which number in the thousands. The dollar amount of Staff's proposed removal from rate base in this case is based upon a Company estimate.

Company also alleges that Staff's proposal to allow the Company to earn a return on the property in question by reason of IDC treatment is more illusory than real. Company avers that Staff's adjustment of depreciation expense would result in a shortfall of capital recovery. It is the Company's position that if the Staff had made adjustments to the depreciation rates used in this case to calculate its recommended depreciation expense to reflect the shortened lives of those projects which would be removed from the depreciation plant categories, the reduced depreciation expense resulting from Staff's removal of these "premature" projects would have been totally offset by higher depreciation rates applied to the remaining depreciable plant categories.

The Commission is not persuaded upon the record herein that Staff's proposal should be adopted. The exclusion of two-month or less, under \$25,000, projects from rate base as CWIP may draw too fine a line between current and future ratepayers, and create accounting and administrative burdens which more than offset any alleged benefits to the current ratepayer.

The Commission finds and concludes upon the record herein that the charging directly to Plant in Service (Account No. 100.1) of projects under construction costing less than \$25,000 or taking less than two months to complete is reasonable, and that Staff's proposal on this issue should be rejected in this case.

C. Uncollected Depreciation and Deferred Taxes

The Company proposed to adjust the reserve for depreciation and accumulated deferred income tax accounts for uncollected portions thereof. The Staff opposed these rate base adjustments. (Hearing Memorandum, Joint Exhibit No. 3). However, prior to the hearing of this issue, the parties reached a settlement as to the issue.

D. Western Electric Profits

The Staff proposes to reduce the Company's intrastate rate base by \$1,529,000 to account for Western Electric pricing which the Staff contends has resulted in excess profits from Western's sales to the Company. The Company opposes the adjustments recommended by Staff, both in principle and amount.

The merits of this issue are discussed under Section IV.D., above. On the basis of the Commission's findings and conclusions therein stated, the Staff's proposed rate base adjustment relating to Western Electric profits is rejected.

E. Original Cost Rate Base

Upon the competent and substantial evidence in this case, and adjusting for the determinations reached on rate base issues above, the Commission finds and concludes that the Company's net original cost rate base is \$1,465,184,000.

VI. Fair Value Rate Base

The Company and the Staff have submitted to the Commission a Stipulation and Agreement as to the fair value rate base to be applied in this case (Hearing Memorandum, Joint Exhibit No. 3, pp. 14 and 15). As a result, the Commission finds that the Company's fair value rate base is \$2,192,000,000.

## VII. Rate of Return

In this proceeding, the rate of return issue is made up of two separate and distinct parts: (1) the weighted cost of capital for the Company's total Missouri operations, referred to as the "total return"; and (2) the weighted cost of capital on the Company's intrastate operations, referred to as the "intrastate return".

### A. Total Rate of Return

#### 1. Capital Structure and Embedded Cost of Debt and Preferred Stock

The Company and Staff agree that the capital structures for AT&T and the Company to be used in this case are those as of April 30, 1982, as presented by the Staff in this case. The stipulated capital structure is based on a sourcing of Southwestern Bell capital to the AT&T (parent only) capital structure. The agreement of the Company and Staff is set out pages 11 and 12 of the Hearing Memorandum in this case (Joint Exhibit No. 3). The Company and Staff have also agreed to the embedded cost of preferred stock and debt, but disagree as to the cost of common equity.

The agreement of the Company and Staff as to the appropriate capital structure and the appropriate embedded cost of debt and preferred stock for use in this case is set forth below:

CAPITAL STRUCTURE AND EMBEDDED COSTS  
FOR USE IN DETERMINING COMPANY'S  
TOTAL COST OF CAPITAL

I. AT&T Parent Cost of Capital

<u>Capital Component</u>	<u>Capitalization Ratio</u>	<u>Embedded Cost</u>	<u>Weighted Cost of Capital</u>
Debt	15.58%	8.02%	1.25%
Preferred Stock	3.60%	7.67%	.28%
Common Equity	<u>80.82%</u>	<u>(1)</u>	<u>(2)</u>
TOTAL	100.00%		(3)

(1) Cost of Equity to be determined by the Commission.

(2) Weighted Cost of Equity calculated by multiplying the Commission-found cost of equity (1) by 80.82%.

(3) AT&T Parent Cost of Capital calculated by adding the weighted cost of equity (2) to the weighted cost of debt and preferred stock.

II. Southwestern Bell Cost of Capital Based on a Sourcing of Its Common Stock to AT&T Parent

<u>Capital Component</u>	<u>Capitalization Ratio</u>	<u>Embedded Cost</u>	<u>Weighted Cost of Capital</u>
Debt	43.13%	9.64%	4.16%
Common Equity			
Common Stock	44.97%	(4)	(5)
AT&T Debt	7.01		
AT&T Preferred	1.62		
AT&T Common Stock	<u>36.34</u>		
	44.97		
Retained Earnings	<u>11.90%</u>	<u>(6)</u>	<u>(7)</u>
TOTAL	100.00%		(8)

(4) AT&T Parent Cost of Capital Determined in Item (3).

(5) Weighted Cost of Common Stock calculated by multiplying the AT&T Parent Cost of Capital (4) by 44.97%.

(6) Cost of Equity to be determined by the Commission. This amount will be the same as used in Item (1).

- (7) Weighted Cost of Retained Earnings calculated by multiplying the cost of AT&T Equity (6) by 11.90%.
- (8) Total Southwestern Bell Cost of Capital calculated by adding the weighted cost of capital components [4.16% + (5) + (7)].

The United States Department of Defense (Defense) takes the position that the capital structure which should be utilized for the Company in this case is the consolidated Bell System capital structure, adjusted to reflect a lower equity ratio. Defense also calculates the cost of senior securities (debt and preferred stock) to be 9.03 percent. Defense argues that the Bell Telephone System is financed as a single enterprise and that, although the operating expenses associated with each unit of the Bell Telephone System may vary due to local conditions, the cost of capital for plant and equipment used to provide exchange or other services does not depend on its particular location. Defense recommends that the Commission use a fifty-fifty capital structure. The Bell System had 53 percent equity as of November of 1981. AT&T has a stated policy of increasing its equity ratio to 55 percent in the next few years. Defense asserts that the Bell System will be able to maintain its financial integrity with a capital structure containing 50 percent common equity, and that the use of a fifty-fifty capital structure in this case would prevent Southwestern Bell from recovering excessive rates based upon an unnecessarily high cost of equity. However, the Commission is not persuaded by the competent and substantial evidence in this record that Defense's proposed capital structure is accurate or reasonable.

The Commission finds and concludes that the capital structure and embedded costs of debt and preferred stock used by the Staff and Company in this case should be relied upon. Those figures, as set out on the chart above, will be utilized in this case. However, a capital structure adjustment may be appropriate at some future time and the Company should be prepared to meet its burden of proof to show its capital structure is reasonable in its next case.

## 2. Return on Common Equity

Having determined the appropriate capital structure and embedded costs of debt and preferred stock for use in this case, a determination is necessary as to the required return on AT&T equity. The required return on AT&T equity is then applied to that portion of SWB's common equity which has been sourced, for purposes of this case, to AT&T parent company equity and to SWB's retained earnings. Evidence was presented as to the required return on AT&T equity by the Company, the Staff and Defense. The recommendations of the parties as to return on AT&T equity are as follows: SWB -- 17.1 percent; Staff -- 14.85 percent to 15.95 percent; Defense -- 13.50 percent to 15 percent.

Each party used a Discounted Cash Flow (DCF) analysis (also known as a market analysis) in the course of developing its recommended rate of return on equity. The DCF analysis is based upon the premise that current investors value a share of stock by projecting the future flow of dividends and future value of the share of stock, and discounting those values to the present time. The DCF attempts to determine the cash flows which an investor can reasonably expect to receive. The basic DCF formula which embodies this analytical approach is as follows:

$$k = \frac{D_1}{P_0} + g.$$

In this equation,  $P_0$  represents stock price,  $D_1$  represents the indicated dividend per share,  $g$  represents an expected growth rate measured in earnings per share or dividends per share, and  $k$  represents the required rate of return. The component of  $\frac{D_1}{P_0}$  is referred to as the dividend yield component of the DCF equation, while  $g$  constitutes the growth component. This basic DCF formula applies only to the cost of common equity obtained from retained earnings. The cost of market-procured equity (external funds) is greater due to the "flotation costs" associated with the sale of

new shares. Thus, for market-procured common equity, the DCF formula is rendered as follows:  $k = \frac{D}{P(1 - f)} + g$ , where  $f$  represents flotation costs as a percent of book value.

In its DCF, the Staff utilized a range of 9.1 to 9.7 percent for the dividend yield component, based on a range of yields between October 1979 and December 1981; and a growth rate range of 5.8 percent to 6.4 percent, based on an examination of historical growth for five, ten and fifteen year periods ending in 1982. Staff also applied a 3 percent adjustment for flotation costs. Staff's DCF analysis results in a recommended return range of 15.2 to 16.4 percent.

Company is critical of the Staff's use of historical and indicated dividend yields, asserting that the proper dividend to be used in the DCF model is the dividend which investors expect over the next twelve months in the future. The Company used a 9.9 percent dividend yield component in its DCF, and an annual growth rate in the range of 7 percent to 8 percent based on what the Company asserts to be empirical evidence as to investors' actual growth expectations, rather than entirely historical data.

Defense used a dividend yield component ranging from 9.5 percent to 10.5 percent, and a growth factor of 3 percent to 4.5 percent.

It is undisputed that investment analysts rely heavily on historical earnings and dividend growth. The Commission finds the Staff's DCF to be the most reasonable and to be well supported by the competent and substantial evidence upon the record of this case.

Staff and Defense also performed comparable earnings analyses in this case, seeking to establish the relative risk of AT&T based on historical data. Staff's analysis compares the book profitability of a selected group comparable to AT&T in order to appraise the Company's current and historic earnings and approximate a fair rate of return for AT&T. Staff determined that other telephone companies represent the most comparable risk substitute for AT&T or any other telephone utility. Staff

studied the average market-to-book ratio (M/B), return on average common equity (ROE), and common equity ratio (EQRAT), for Central Telephone (Centel), Continental Telecom, Inc. (Continental), General Telephone & Electronics Corp. (GTE), Mid-Continent Telephone Corp. (Mid-Continent), and United Telecommunications, Inc. (United), for the years 1971 through 1981 and for the 12-month periods ending March 31, 1982, and May 31, 1982. This analysis indicated the following:

	<u>M/B</u>	<u>ROE</u>	<u>EQRAT</u>
Other Telephone Companies 1977 Through Current	1.10	.1553	.3547
AT&T 1977 Through Current	.90	.1284	.5117

Staff's study indicates that the EQRATs of AT&T are considerably higher than those of the non-Bell composite, indicating that AT&T's required return would be less than that of the non-Bell companies. Staff concludes that ROEs in the range of 14.5 to 15.5 percent should result in favorable investor appraisal of AT&T stock, and even lower returns may prove adequate if market conditions improve.

Staff also compared AT&T with a composite of the companies making up the Dow Jones Industrial Stock Average from 1971 through 1981, with the companies making up Standard & Poor's (S&P) 400 (less AT&T), and for the companies included in the Compustat II Industrial computer file. ROEs for the Dow Jones Industrials have ranged from about 10 percent to a little over 14 percent in the period 1974 through 1981, and have averaged about 12.4 percent. The average ROE for the S&P 400 from 1977 to 1981 was 15.47 percent, and for the Compustat Industrials was 15.46 percent. Based on this data, Staff concludes that returns in the range of 14.5 to 15.5 percent are reasonable for the Company.

The witness for Defense performed a similar study, which he called a relative risk and earnings approach analysis, comparing AT&T stock to Moody's Utilities and Standard & Poor's Utilities (hereinafter, Utilities) and to Standard & Poor's Industrials (hereinafter, Industrials). Defense concludes that AT&T is

associated, in investors' eyes, with less investment risk than the Industrials; that the overall investment risk associated with AT&T has not changed during the past few years; that AT&T's decreasing market values are the result of conditions affecting the market as a whole and are not the result of a change in AT&T's business or investment risk; that AT&T has maintained the highest levels of financial strength while earning lower returns on invested equity than the Industrials; and that earnings of 12.5 to 13.5 percent for AT&T are comparable to the current earnings of the Industrials.

The Company also offered a series of comparable earnings analyses intended to confirm that the specific return indicated by the Company's market analysis was reasonable. These analyses compared AT&T's indicated return from SWB's market analysis with the "expected market return range" for the S&P 500; and compared the actual earned returns of two market aggregates (the S&P 500 and the 900 Company Group, both excluding AT&T).

The witnesses for Company and Staff also recognized the need for an upward adjustment to AT&T's required market return so that net proceeds from a market sale of common stock would be at least book value or above. In their DCFs, Company recommended a 5 percent adjustment for this purpose, and Staff's witness included such an investment in his 3 percent "flotation costs" figure.

The Commission finds that the Staff's analyses of the appropriate rate of return on equity are the most reasonable. Staff's proposed range of 14.85 to 15.95 percent represents the averaging of the high and low ends of the ranges indicated by the separate analyses of the Staff.

The Commission finds and concludes that the appropriate rate of return on equity which should be authorized in this case is 15.45 percent. Applying this figure to the capital structure adopted above results in an overall rate of return of 12.30 percent.

B. Intrastate Rate of Return

The Staff proposes to adjust the Company's total cost of capital as determined above, to account for varying return requirements of Company's allegedly different lines of business and its Missouri intrastate rate base. Staff asserts that in order for the Company to have the opportunity to earn a return of 12.01 percent to 12.54 percent on a total Company basis (the range of Staff's recommendation in this case), the Company must earn a return of 11.50 percent to 12.15 percent on its Missouri intrastate rate base. Staff presented the testimony of Dr. Michael Ileo on this issue.

It is Staff's position that there is sound basis from an economic perspective for allowing the Company to earn different rates of return on its various lines of intrastate business, because perceptible differences in risk exist among the Company's various lines of business. Dr. Ileo submits that the Company's intrastate operations can be viewed as divisions or private centers consisting of local exchange operations, nonexchange or vertical services operations, and intrastate toll operations. According to Ileo, Southwestern Bell's total Company operations can be divided into four categories: local exchange, nonexchange, intrastate toll and interstate toll. Each of these aggregate lines of business of the Company have different risk characteristics and, hence, different rate of return requirements, in Ileo's view.

Dr. John W. Wilson took a similar approach to that of Dr. Ileo, but proposed that SWB's total operations could be disaggregated into three lines of business, instead of four, as follows: monopoly business, competitive business, and potentially competitive business. Dr. Wilson identified interstate toll, customer premises equipment, and interstate private line services as being "competitive", and intrastate toll and intrastate private line as being both "potentially competitive" and "monopoly" services. Both Wilson and Ileo believe that the local exchange

operations of Southwestern Bell have a much lower overall risk than the total Company operations and should, therefore, have a lower return and a higher debt ratio.

Public Counsel witness Gabel also testified that the Company can be disaggregated into various lines of business, such as local exchange, interstate toll, intrastate toll, and vertical services, and that because of the variation in risk uncertainty respecting the various service classifications it would be appropriate to assign different rates of return to these different lines of business. Mr. Gabel identified competition as the risk uncertainty to which he referred.

Staff's assertion that different business risks exist among the Company's various lines of business is based upon a number of factors. First, because of competition, the Company currently faces greater business risk in providing terminal equipment and toll services than other services. Also, business toll use is more directly subject to swings in general economic activity than residential local exchange service. In addition, Staff asserts that AT&T's plan to finance American Bell, Inc., with virtually 100 percent equity indicates that nonexchange business entails a high degree of business risk. Further, the Company has proposed in this proceeding (as it has in the past) to price vertical and other competitive services in excess of long run incremental costs, so that the implicit rates of return associated with these services will be greater than the implicit rates of return associated with local exchange service. Staff asserts that regulation has traditionally recognized that greater risk requires a higher rate of return, and submits that regulators, investors and telephone industry analysts alike recognize that toll and vertical services pose greater business risks than local exchange business for predivestiture telephone companies. Finally, Staff avers that the sales of Western Electric (the Company's principal supplier of vertical services equipment) have been more volatile than Bell System revenues because Western Electric is not insulated from swings in economic activity; that Western Electric is in a technologically dynamic business and the risks associated with innovation are greater

for such companies; that Western Electric's business risks have been comparable to those of other manufacturers and greater than the business risk of utilities; and that Western Electric's sales and earnings volatility have an impact on the proportion of debt that it can carry in its capital structure.

Dr. Ileo recommended rates of return for the four aggregate lines of business on the basis of his assessment of relative business risk and its implication for the underlying capital structures for the Company's various lines of business. While Staff insists that Dr. Ileo does not recommend capital structures for the four aggregate lines of business which he identifies, the distinction the Staff seeks to draw is too fine a line for the Commission to discern. As a practical matter, Dr. Ileo's ultimate recommendation depends in substantial portion upon the reasonableness of the underlying capital structures for the disaggregated lines of business which are "implied" by his assessment of relative business risk. As Company points out, a recommended return for each line of business is meaningless without a recommended capital structure.

The respective methodologies of Wilson and Ileo result in the assignment (implied or otherwise), of the following debt ratios to the various lines of the Company's business:

	<u>Recommended Debt Ratio</u>
<u>Dr. Wilson</u>	
1. Monopoly operations	61 %
2. Competitive operations	56.9 %
3. Potentially competitive operations	55.7 %
<u>Dr. Ileo</u>	
1. Interstate toll line of business	35. %
2. Intrastate toll line of business	55.17%
3. Nonexchange line of business	12 %
4. Exchange line of business	64 %

Ileo ultimately concluded that the appropriate Missouri intrastate rate of return for the Company is in a range of 11.50 percent to 12.15 percent. Dr. Wilson determined that the Company's Missouri jurisdictional cost of capital is 11.85 percent, based upon the midpoint of Staff witness Shackelford's range of AT&T (parent only) cost of common equity.

The Company submits that the risks of the various business segments of the Bell System cannot be disaggregated at this time and that those risks, if not identical, are so similar that they cannot be quantified. The Company also denies that divestiture will necessarily result in significantly changed levels of risk, but asserts that perceived risks in postdivestiture local exchange business may in fact be greater than in interstate toll business. Southwestern Bell submits that the required return for the Company's intrastate operations is at least as high as the required return for its total operations.

The Company is critical of Staff's reliance on competitive risk as the basis for distinguishing the Company's lines of business for rate of return purposes. While the Staff offered evidence as to comparative competitive risk facing the segregated portions of the Company's business, Company says the Staff failed to offer evidence of the total comparative risk facing any given line of the Company's business. Thus, Company asserts that no basis exists in the record for a rate of return finding based on the weighted average of the various costs of capital associated with the allegedly different risk levels. The Company asserts that significant risks other than competition can be identified, such as regulatory risk, legislative risk, judicial risk and technological risk. Staff asserts in response, however, that since all of the Company's lines of business are affected by the other risks denominated by the Company, competitive risk is the only basis for distinguishing the Company's lines of business for rate of return purposes. Company asserts that local exchange service is more exposed to inflationary risks than is toll service, and that the beginnings of competition in alternative local

distribution systems are being seen. It is the Company's view that analysts and investors are at least as concerned with the risk connected with local exchange operations as they are with any other specific operation or with the Bell System in total. However, neither of the Company's witnesses could provide any quantification of the level of competition offered by alternative local distribution systems. Staff also provided evidence indicating that in the near-term, the BOCs' monopolistic market position within the local exchange and toll access markets will remain relatively unscathed.

The Company asserts that there is no evidence in the record that the capital structures (implied or otherwise) relied upon by Drs. Ileo and Wilson for their calculation of a proposed intrastate rate of return, are appropriate or reasonable for those lines of business as viable stand-alone business entities. In fact, Dr. Ileo testified that he had not viewed the separate lines of business on a stand-alone basis as to their actual operations or managerial functions so as to determine whether each line of business could be financially viable as a stand-alone entity. Company avers that the methodologies of Ileo and Wilson used debt costs which are totally unrelated to the level of debt ascribed by those witnesses to the various lines of business. For example, Company notes that Dr. Ileo posits a 64 percent debt ratio for the local exchange line of business, but at a cost of debt equal to Southwestern Bell's current cost at a 43 percent debt ratio. Company presented evidence to the effect that an increase in debt ratio results in an increase in the cost of new debt, resulting further in an increase in the cost of embedded debt and of the firm's financial risk. As the financial risk accelerates, the cost of equity will also increase at least proportionately, and possibly even at a higher rate. Thus, the Company asserts that a 64 percent debt ratio would cause a regulated utility an increase in its cost of debt and equity, a fact which was ignored by Drs. Wilson and Ileo in their analyses. Company also presented evidence indicating that major rating agencies believe that local exchange businesses will

need to maintain at least as strong a capital structure after divestiture as the BOCs have maintained over the years.

One of the Company's witnesses states that the business segments identified by the Staff cannot yet be treated as independent stand-alone entities, but rather are critically linked by a series of interdependent rates and joint costs. It was this witness' opinion that knowledgeable investors and professional analysts know that such independence does not exist and that the risks of the segments of the Company's business cannot be disaggregated.

The Commission is of the opinion that differences in risk probably do exist among Southwestern Bell's various lines of business. This could be of particular importance in the Company's next general rate case since a number of the Company's more competitive lines of business will be spun-off on or before February 24, 1984, as a result of the Modified Final Judgment. However, the Commission cannot conclude upon the evidence before it that lines drawn in the disaggregation process are appropriate or that the risk differentials have been quantified with reasonable accuracy. Several of the Company's criticisms were not adequately addressed by other parties in this record. The Commission finds and concludes that the Staff's proposed adjustment on this issue should be rejected.

Nonetheless, the Company should be prepared to meet its burden of proof in its next general rate case to show that its position that no disaggregation is proper and that no quantifiable risk differentials exist, is reasonable. The Commission expects the presentation in SWB's next rate case of various methodologies designed to assess any quantifiable risk differentials of Southwestern Bell's Missouri intrastate lines of business.

For the reasons stated above, Staff's proposed intrastate rate of return will not be utilized for purposes of this case.

### C. Summary

Based upon a finding in this proceeding that AT&T's required return on equity is 15.45 percent, and upon the Commission's rejection of the Staff's intrastate rate of return adjustment, SWB is authorized to earn a return of 8.22 percent on its fair value rate base, which the Commission finds is reasonable.

### VIII. Separations

Separations is the process by which the Company's total expenses, taxes and investments are divided between the state and interstate jurisdictions. Generally, the separations process is accomplished in accordance with the Separations Manual of the National Association of Regulatory Utility Commissioners (NARUC) and the Federal Communications Commission (FCC). The Company and the Staff have presented four separations issues to the Commission for resolution in this case.

#### A. Interstate Foreign Exchange

Interstate foreign exchange (FX) service is a combination of private line and exchange services. It enables a customer in state A to access, by means of an interstate private line, a local exchange in state B as if his phone were located in state B. The customer in state A can, by means of this arrangement, place calls like any other subscriber in the local exchange of state B. Similarly, callers in the local exchange of state B can access the interstate FX customer's line as if it were any other local line located in that exchange. No toll charge is incurred in either case. The local exchange which can be accessed by the interstate FX (the local exchange in state B in the illustration above), is known as the "open end".

FX service is provided under two separate tariffs. The interstate private line facilities associated with the service are provided under FCC Tariff No. 260. The exchange facilities are provided under the local exchange tariff prevailing in the open-end jurisdiction.

Common Control Switching Arrangement (CCSA) provides a customer with a leased private line telecommunications network, including dedicated lines and

switches, which the customer can use to communicate between the points on its systems. CCSA customers can also obtain local off-network access lines (LONALs) and off-network access lines (ONALs) which can be used in much the same manner as FX service in a distant city. The CCSA customer receives separate bills for the private line and the origination and termination service at the open end. The latter is billed at the business local exchange tariff rate.

Under the Separations Manual, 100 percent of the investment, expenses and revenues associated with the interstate private line links utilized in interstate FX and CCSA services are directly assigned to the interstate jurisdiction. On the other hand, all of the investment, expenses and revenues associated with the usage of the local exchange service links in the provision of interstate FX and CCSA services are assigned to the open-end jurisdiction at the present time. Southwestern Bell asserts that the assignment of the minutes of use associated with these services to the open-end (Missouri) jurisdiction is consistent with the longstanding application of the Separations Manual. However, the Staff contends that the minutes of use associated with these services are interstate rather than local in character, and should be counted as such in the derivation of the various factors used to separate Company's investment and expense. The assignment of these minutes of use to interstate, rather than Missouri intrastate, jurisdiction, in accordance with the Staff's proposal in this case, would reduce the revenue requirement of the Company by \$4,259,000.

The Staff contends that FX and CCSA service are, overall, integrated end-to-end services, and that both the private lines and the local exchange service are part of those integrated end-to-end services. On the other hand, the Company asserts that FX and CCSA are each a combination of two services: one service being an interstate private line, under FCC jurisdiction, and the second service being an intrastate exchange service under state jurisdiction.

The Company asserts, further, that the present Separations Manual requires that the costs associated with the local exchange minutes of use of FX and CCSA services must be assigned to the intrastate, rather than the interstate, jurisdiction. The Company asserts that intrastate assignment of these minutes of use was specifically contemplated by NARUC and the FCC in the adoption of the Ozark Plan (the last state-federal agreement for allocating exchange plant costs to be incorporated into the Separations Manual); and that virtually every FCC and court decision which has considered the issue has come to the conclusion that the costs at issue must be recovered in the state jurisdiction or not at all. The Company also points out that the FCC has specifically assigned this question to the existing federal-state Joint Board for its consideration in Docket No. 80-286 [89 F.C.C.2d 1 (1982)]. Therefore, Company asserts that if the Commission adopts Staff's position on this issue, a portion of the Company's known revenue requirement would fall into a "jurisdictional crack" and be unrecoverable by SWB, a result which SWB describes as "confiscation".

On the other hand, the Staff asserts that the Separations Manual is silent or, at best, ambiguous as to the treatment to be given the exchange minutes of use portion of FX and CCSA service, and that those services are clearly integrated end-to-end interstate services over which federal jurisdiction has long been recognized as paramount. Further, the Staff urges the Commission no longer to await action by the Joint Board, since that is essentially what the Commission did three years ago (in P.S.C. Case No. TR-79-213) and the Joint Board still has not acted on the matter.

The Commission believes that FX and CCSA services are integrated end-to-end interstate services which should be under the jurisdiction of the FCC. Each time those services are utilized, a party in one state communicates with a party in another state. To treat any part of the provision of those services as intrastate is pure fiction. That determination by this Commission leads to the conclusion that, in theory, the Staff's proposed adjustment is sound.

However, the Commission is mindful that implementation of this decision would open a "jurisdictional crack", so that SWB would be unable to recover a portion of its revenue requirement either from the FCC or this Commission.

The courts have addressed this issue. In New York Telephone Co. v. Federal Communications Commission, 631 F.2d 1059 (2nd Cir. 1980), the United States Court of Appeals for the Second Circuit affirmed an FCC order which declared a New York Telephone Company (NYTC) tariff to be unlawfully discriminatory. The tariff at issue would have imposed a surcharge on interstate FX customers designed to recover the portion of revenue requirement disallowed by the New York Commission on reasoning similar to that advocated by the Staff in the instant case. The Second Circuit Court of Appeals held as follows:

In the final analysis, as at first blush, this case is really an administrative jurisdictional dispute, with NYT and interstate FX and CCSA users to some extent caught in the middle. Upholding the FCC order, we force NYT to go back to the state for a new tariff that is consistent with the FCC's March 12 order, as the telephone companies have done in the California and Missouri cases. Of course, NYT may instead file a new tariff with the FCC, but the future Joint Board proceedings on all separations procedures may delay approval for at least a year. To hold otherwise in this case would permit the PSC to export intrastate telephone costs to interstate users until separations procedures have been revised and all interests accommodated. In the words of a dissenting PSC member, "[u]niformity in procedures used to allocate costs among the many jurisdictions involved is vital," in fairness to telephone company and ratepayer alike. The FCC appears to be seeking such "separations" uniformity in an orderly way, used successfully for more than thirty years, which saves state and private parties alike considerable litigation expense. The PSC order abrogated by the FCC order which we affirm would do just the opposite.

A New York state court reached the same result upon a petition filed there seeking to enjoin the New York Telephone Company surcharge tariffs. New York Tel. Company v. Public Service Commission, \_\_\_ A.2d \_\_\_ (N.Y. S.Ct., App. Div., 3d Dept., No. 38382, decided \_\_\_\_\_). Further, the Supreme Court of the State of Maine reversed a Maine Commission FX/CCSA adjustment in New England Telephone and Telegraph Co. v. Public Utilities Commission, et al., 448 A.2d 272, 300 (Me. 1982) with this language:

In the present case, the Commission's allocation of FX plant costs to the interstate jurisdiction, contrary to the FCC's practice, disregards the balancing arrangements under which the FCC-NARUC plan has been administered. Regardless of whether the Commission is bound by federal action in allocating NET's interstate FX minutes of use, it should defer to the practice currently followed by the FCC in carrying out the understandings embodied in the Separations Manual. Considering the importance of uniformity in the federal and state regulation of telecommunications, the desirability of according comity to FCC practice in this matter, and fairness in the treatment of NET, we believe that the Commission acted unreasonably in allocating the costs in question to the interstate jurisdiction.

The Commission finds and concludes that it would not be reasonable to make Staff's suggested adjustment in this case.

B. Five-day Versus Seven-day Studies

The Staff proposes to reassign approximately \$12,080,000 in annual state revenue requirements to the interstate jurisdiction, based on its contention that SWB should calculate certain components of the minutes of use study on a seven-day basis, rather than on the currently employed business day or five-day basis. The sample studies at issue here are conducted in order to develop the average duration of exchange and toll calls (holding time per call). Measurements of toll (both state and interstate) and total office usage are taken over a period of five business days. Exchange usage is developed by deducting toll usage from total office usage. Concurrent with this usage measurement, counts of toll messages (both state and interstate) as well as exchange calls are taken. Toll holding times are developed by dividing the toll usage measurement by the counts of toll messages. Exchange holding times are developed by dividing the exchange usage by exchange calls. These holding times are then used to develop total study area exchange, state toll and interstate toll minutes of use by multiplying total month study-area calls and state and interstate toll message volumes by their holding times developed in the five-day study. Five-day studies have been employed for these purposes by Southwestern Bell in Missouri for many years, as well as by other Bell companies throughout the nation.

Two major Separations Manual usage factors are based on the results of the five-day studies. These two factors are the subscriber line usage (SLU) factor and the dial equipment minute (DEM) factor. The importance of the SLU factor is that it was used in the development of the 1980 subscriber plant factor (SPF) which was then used to develop the frozen SPF (discussed further below, under Section VIII.C).

The Staff points out that the Company uses both five-business-day and seven-calendar-day usage studies, for different purposes. For interexchange facilities, the Company samples the usage (holding time or minutes of use data and number of messages) on the basis of seven calendar days to measure interstate and intrastate usage. However, for station equipment, local loops and local switching equipment for interstate toll (MTS) and interstate WATS usage, the Company uses number of messages on the basis of seven calendar days and holding time data on the basis of the five business days (exclusive of the weekend holding time data). Thus, the Company excludes weekend holding time data in the calculation of SPF and of dial equipment minutes. The Company's methodology, Staff alleges, understates interstate usage of station equipment, local loops, and local switching equipment; underallocates expense and investment of station equipment, local loops and switching equipment to interstate; and, thereby, overallocates the Company's revenue requirement to the Missouri intrastate ratepayer. It is Staff's position that seven calendar day holding time data should be used in determining the allocation of the expense and investment respecting station equipment, local loops and local switching equipment.

The average duration in minutes of interstate toll (MTS) calls is longer during the weekend than during the weekdays, possibly because of the lower interstate rates that are in effect on the weekend. In 1981, SPF inclusive of weekend holding time data was 0.2839, but SPF exclusive of weekend holding time data was 0.2626. Paragraphs 11.212 and 11.15 of the Separations Manual indicate that (1) any studies or measurements must be performed during a representative period in a manner that

clearly reflects actual use, and (2) companies are allowed to use shortcut procedures provided that the shortcuts are applied in a manner that does not distort the results. Neither five-day studies nor seven-day studies are specifically required by the Separations Manual.

The existing Joint Board is under directions from the FCC to consider whether seven-day study periods should be substituted for existing five-day study periods, in FCC Docket No. 80-286. AT&T has proposed that the seven-day studies be utilized, and SWB supports that proposal. However, SWB further states that this Commission must await the Joint Board's recommendation and the FCC's approval of that change before making any adjustments to Missouri intrastate rates on the basis of seven-day study data. The Company asserts, as it did concerning interstate FX and CCSA services, that unilateral action by this Commission prior to action by the Joint Board would result in Southwestern Bell's inability to recover an admitted portion of its revenue requirement in either the state or interstate jurisdictions.

The Commission believes that Southwestern Bell should calculate holding time (minutes of use) data for station equipment, local loops and local switching equipment for interstate toll (MTS) and interstate WATS usage on the basis of seven-day studies, instead of the five-day studies currently employed. Other companies do so at this time. The Commission finds that the use of five-day studies overallocates the Company's revenue requirement to the Missouri intrastate ratepayer; that five days is not a representative period clearly reflecting actual use, as required by the Separations Manual; and that the use of five-day studies distorts the results of such studies.

However, the Commission is mindful of the impact that implementation of this decision would have on SWB's ability to recover its revenue requirement. Therefore, the Commission finds and concludes that it would be unreasonable to make the adjustment in this case. However, the Company should actively pursue corrective FCC action in order to avoid any future shortfalls should the Commission subsequently make this adjustment.

C. Frozen Subscriber Plant Factor (SPF)

By its Decision and Order adopted February 24, 1982, and released February 26, 1982, the FCC adopted the recommendation of the previously convened federal-state Joint Board to freeze the subscriber plant factor (SPF) at the average 1981 annual level as an interim measure pending the development of final, more comprehensive changes to separations procedures. FCC Decision and Order, Docket No. 80-286, Released February 26, 1982. SPF is a derived factor used to allocate investment in station equipment, subscriber lines and the non-traffic-sensitive portion of central office equipment to the interstate jurisdiction. SPF is derived through a formula set forth in Section 23.444 of the Separations Manual. That formula is generally rendered as  $SPF = .85 SLU + (2 SLU \times CSR)$ , where SLU is a measure of subscriber line usage and CSR is the composite station rate.

In this case, Staff concedes that the Company is required to freeze the interstate SPF and use that frozen factor in the separation of its Missouri investment and expense between the state and interstate jurisdictions from and after the implementation date of the FCC Order (April 1982). However, the Staff asserts in this case that Southwestern Bell has not frozen the SPF in compliance with the FCC's Order and that Southwestern Bell's noncompliance overstates the Company's Missouri intrastate revenue requirement by \$3,005,000. More specifically, Staff contends that the FCC intended to freeze the SPF factor relating only to message telephone services (MTS) and wide area telecommunications services (WATS) offered by the Bell System, and did not intend to freeze the SPF related to similar, if not identical, services offered by Other Common Carriers (OCCs) such as MCI Telecommunications Corporation and Southern Pacific Communications Company. Staff relies essentially on its observation that the FCC Order freezing SPF did not expressly state that the SPF associated with OCC toll-substitute services should also be frozen.

To offer its interstate MTS and WATS services, AT&T must connect its facilities to the local exchange facilities of the various operating telephone

companies. The local operating companies receive compensation for the use of their local facilities through the division of revenue process. To offer their services, MCI and Southern Pacific must also connect their facilities to the local exchange facilities of the operating telephone companies. The Bell System and the OCCs have negotiated exchange network facilities for interstate access (ENFIA) agreements, filed as tariffs with the FCC, providing for compensation to the operating companies from the OCCs for the use of operating company local facilities. Under the ENFIA agreements, the operating telephone companies are compensated for the use of these facilities directly from the OCCs, and not through the division of revenue process.

Based upon the evidence in this case, the Commission finds and concludes that the Company's interpretation of the FCC Order is reasonable. Evidence provided by Staff has not shown otherwise. The Commission's view of this matter is consistent with that of the Chief of the Common Carrier Bureau of the FCC, who advised Staff's witness on this issue that the FCC had intended to include ENFIA minutes of use in arriving at the appropriate level of frozen SPF. (Late-filed Exhibit No. 233).

The Staff's proposal is rejected.

D. Phasedown of Customer Premises Equipment (CPE)

In the same Decision and Order in which it directed the SPF factor to be frozen at the average 1981 level, the FCC also adopted a plan for the gradual removal of customer premises equipment (CPE) from the separations process. FCC Decision and Order, Docket No. 80-286, Released February 26, 1982. Under this plan, no investment or expenses associated with CPE incurred after January 1, 1983, will be allocated to interstate operations. The amounts in the CPE plant on the books as of that date, and the average amounts in related expense accounts for the previous year, will constitute a "base amount" for separations purposes. The base amount will be reduced at the rate of one-sixtieth per month over a period of five years.

Company proposes in this case to include in its intrastate revenue requirement \$3,624,000 to account for the impact which the adoption of the CPE

phasedown will allegedly have on its financial operations in calendar year 1983. Company asserts that, although the Company's expenses and investment associated with CPE will gradually be reducing, the Company will also be losing intrastate tariff revenues generated by terminal equipment. The Company also asserts that the intrastate jurisdiction has enjoyed a contribution by reason of the assignment of significant portions of the costs of terminal equipment to the interstate jurisdiction and the recovery of those costs through the division of revenue process. It is the gradual loss of this alleged contribution previously received from the interstate jurisdiction upon which the Company's intrastate revenue requirement adjustment is based.

The Staff opposes the Company's adjustment, primarily on the basis that it goes outside of the test year in this case. The test year, as discussed hereinabove at Section III, is the 12-month period ending April 30, 1982, as updated for known and measurable changes through September 30, 1982.

The Commission determines that the Company's proposal should be rejected. While the Company asserts that the revenue requirement impact of the CPE phasedown is "known", the Commission finds that such impact is not "known and measurable" as that term is otherwise used in this case. Company's proposal would adversely affect the integrity of the test year, in that revenues, expenses and investment would not be adequately matched under the Company's proposal. If the CPE phasedown were to be addressed in the revenue requirement determination in this case, as proposed by the Company, then the Commission would also have to look at the revenue requirement impact of other "known" events which are outside of the test year (as tried up), such as the transfer of certain assets and personnel from Southwestern Bell to American Bell, Inc., in order to implement the FCC's Decision in Computer Inquiry II (discussed elsewhere in this Report and Order under Section XV, "Public Counsel Motion For Separate Docket"). While perhaps balancing the error, even that course of action would not save the integrity of the test year concept. The Commission

concludes that a proper matching of revenues, expenses and investment for purposes of determining Company's revenue requirement in this case cannot be accomplished if the Company's proposal on CPE phasedown is accepted.

Further, the Commission finds and concludes that the Company has not met its burden of proving that the phasedown of embedded CPE in 1983 will, in fact, result in a decrease in Missouri intrastate revenues in the amount alleged by the Company due to a loss of subsidy of intrastate services, other than CPE, by interstate CPE. The Company's hypothetical evidence in this regard is insufficient to meet the burden of proof.

For these reasons, the Company's proposal is rejected.

#### IX. Settlements

By stipulation set out in Exhibit No. 160, Staff, Company and Public Counsel agree that the gross-up of any revenue requirement increase in this case for Independent Company Settlements as calculated in Company's prefiled direct case is appropriate, subject to the Staff's proposed refinement of the annualization of toll revenues as adopted in Staff's current filing. Those parties stipulated and agreed to include Staff's adjustment to annualized settlements in the true-up hearing in this case and to use at the true-up the procedure utilized by Staff. The Commission is of the opinion that the stipulation regarding Independent Company Settlements should be adopted, except that the uncollectable gross-up factor which should be utilized in the calculation is the Staff's proposed uncollectable factor of .006418. (See Section IV.F and G).

#### X. Quality of Service

The Company asserts that it is providing high quality telephone service to its Missouri customers, and is currently meeting all of this Commission's surveillance levels as set out in 4 CSR 240-32.080, on a state-wide basis.

The Commission Staff investigated the Company's service quality in accordance with rule 32.080, and found the Company's service quality at an acceptable

level in most exchanges. However, the Staff found that service in the Old Appleton, Pond, and Portage des Sioux exchanges is not at an acceptable level, and requests six monthly reports from the Company on those exchanges.

Staff also investigated faults in cable pairs located in outside plant facilities. Such faults may affect customer service either presently or in the future. Staff recommended that the Commission order the Company to submit a progress report to the communications department staff every 30 days to report on the status of all the major faults located by Staff which the Company had not eliminated by the end of the hearing in this case. The Staff recommends that such reports continue until the Company has eliminated all the major faults which the Staff located.

The Company agrees to comply with Staff's request for six monthly reports on certain service levels provided to the exchanges of Old Appleton, Pond and Portage des Sioux. The Company also agrees to keep the Staff and the Commission advised on a regular basis regarding the Company's efforts to eliminate the major cable faults identified in Staff's testimony. Such reports will be filed with the Secretary of the Commission pursuant to the timetables suggested by the Staff.

The Public Counsel believes that the quality of service provided by the Company exceeds the Commission's standards by an excessive amount, thereby imposing unnecessary costs upon Missouri ratepayers.

The Commission finds and concludes that the Company's quality of service meets the standards required by Commission rule 4 CSR 240-32.080, except in the Old Appleton, Pond and Portage des Sioux exchanges. The Commission further finds and concludes that the agreements reached by the Staff and Company concerning the filing of reports by the Company on service levels in those three exchanges, and concerning the Company's progress in eliminating major cable faults as identified by the Staff in this case, are reasonable and should be approved.

## XI. Capital Recovery

### A. Expensing Station Connections (ESC)

SWB seeks authorization from the Commission in this case to implement a plan for the phased-in expensing of the inside wire portion of station connection costs. Station connection costs include the costs of labor and material associated with installation, reinstallation and reconnection of station apparatus. Historically, the Commission has accorded capitalization treatment for ratemaking purposes of station connection costs. The expensing plan proposed herein by SWB is consistent with action authorized in 1981 by the Federal Communications Commission (FCC).

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

By its Report and Order in Docket No. 79-105 (adopted on November 6, 1980, and released on March 31, 1981) the FCC ordered a modification of the Uniform System of Accounts to accomplish a movement to the expensing of station connection costs. Previously, all station connection costs (both inside and outside wire) had been capitalized in Account 232, with recovery of such costs spread over the life of the service connection. Through its Report and Order the FCC determined: (a) that the "inside wire portion" of Account 232 should be expensed (that is, reflected on the company's books of account as an expense during the accounting period in which the

cost is incurred) and that the outside portion of said account should continue to be capitalized; (b) that embedded investment related to inside wire contained in Account 232 should be amortized over a ten-year period; and (c) that the carriers affected by said Report and Order should move to the expensing of station connections-inside wire over a four-year phase-in period or, with state commission approval, could elect to institute a "flash-cut" under which immediate expensing of such costs would take place. The FCC directed that carriers affected by said Report and Order comply with the above-described revision of Account 232 no later than October 1, 1981, and permitted retroactive booking in accordance with said revision to January 1, 1981. SWB chose to book the expensing of station connections-inside wire retroactively to January 1, 1981, but the Company is presently also maintaining side records reflecting capitalization of such costs.

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

In its Report and Order in Case No. TR-81-208 (issued November 27, 1981), the Commission rejected the Company's initial proposal to implement ESC. In reaching that decision, the Commission concluded that station connections-inside wire costs are in the nature of a capital investment which results in a flow-back of revenues to the Company over a period of years. The Commission concluded that such expenditures, in the absence of the existence of some other overriding consideration, should be accorded capitalization treatment.

The Commission noted in its Report and Order in Case No. TR-81-208 that the ESC issue was also pending before the Commission in a generic docket at that time (Case No. TO-82-54). The Commission stated that it was willing to consider any

further, relevant testimony regarding the ESC issue in the context of that docket. After a prehearing conference in Case No. TO-82-54 failed to establish a mutually agreeable schedule of proceedings in that case, the Staff and the Company filed a Stipulation agreeing that the ESC issue should be presented again to the Commission in the context of Case No. TR-82-199. By Order dated August 6, 1982, the Commission accepted the approach suggested in the Stipulation, and additional testimony on the ESC issue was then filed by the Company and the Staff in the instant case. The Company and the Staff also jointly sponsored as an exhibit in this case the entire record regarding the ESC issue from Case No. TR-81-208 (Exhibit No. 129).

The Company argued in Case No. TR-81-208, and argues again in the instant case, that capitalization of inside wiring expenses is associated with the goal of universal telephone service and that, because that goal has largely been realized in Missouri (approximately 95 percent of Missouri households have telephone service), a change in accounting is appropriate. The Company also argues, as it did previously, that not all of the costs associated with station connections-inside wire are capital in nature in that certain costs have no useful life beyond one customer; and that amounts in Account 232 have grown at a faster rate due to "churn" (station connection activity resulting from customer movement). The Company argues that ESC is essential in order to ensure the assignment of costs to the cost-causative customer, and that such an assignment of costs was one of the primary goals of the FCC in requiring ESC in Docket No. 79-105. The failure to expense station connections, according to the Company, results in a mismatch of revenues and expenses, while ESC results in a financial benefit to the ratepayer in that continued capitalization requires revenues to cover a return and taxes on the investment, in the Company's view.

The Staff's position in Case No. TR-81-208 was that the appropriate accounting for station connections is an accounting question and that capitalization is appropriate for Account 232 because, taken in the aggregate, the expenditures result in assets of lasting value with a useful life of one year or more

which produce a stream of revenues extending into future years. The Commission agreed with the Staff, finding that the aggregate investment constituting the inside wire portion of station connection costs has, on average, a useful life in excess of one year, and possibly in the range of three to four years, which should be viewed as an investment necessary for the flow of revenues back to the Company. Having made that determination, the Commission found that "assignment of the cost to the cost-causer, if that is the desired goal, is a matter of rate design and is separate and apart from expensing versus capitalization considerations." [Report and Order, Case No. TR-81-208, p. 32].

In the instant case, the Company also asserts that significant regulatory changes have occurred in the area of service connection charges since the Commission's decision in Case No. TR-81-208 which the Company believes represent "overriding considerations" which call for the approval of ESC by this Commission. For example, in residential installations occurring during the test year, the Company did not send a service technician to the premises or install any inside wire in more than 50 percent of the processed service orders; approximately 84 percent of the Company's customers pick up their telephone sets at PhoneCenter stores; and in 72.3 percent of all inward residential installation service orders occurring during the test year, no telephone company work was required inside the customer's premises. The job functions associated with a typical service order are the issuance of the service order, PhoneCenter distribution of the telephone sets, assignment of the service order, installation force management control, distribution of the service order, central office framework, testing of the service order, and completion of the service order to the service order completion center. Currently, all of these activities are expensed, with the exception of assignment, distribution and service order completion, which Company proposes to expense in the instant case. The Company also proposes to expense the costs associated with reconnection of the existing drop wire and field cross-connections if such activities are required on a particular

order. Company believes that it is inappropriate to continue to capitalize costs associated with the service order process and other functions performed by the Company for ratemaking purposes when a majority of service orders no longer require a premises visit by a Company installation technician and, in at least 72.3 percent of the residential installations in the test year, no inside wire was even placed by the Company. On the other hand, the Staff asserts that these facts also indicate that in a vast majority of cases customers are not requiring movement of the inside wire and are, in fact, reusing inside wire already in place.

Company points out that as a result of the Commission's decision in Case No. TR-81-208, service connection charges for the trip, premises wiring and station handling functions included in a service connection are fully compensatory. Company asserts that fully compensatory service connection charges are desirable because installation expenses are nonrecurring in nature and readily associated with an individual customer, and make it possible to associate a specific cost with the cost-causative ratepayer at the time the cost is incurred. The Company does not propose to change the service connection charge established in Case No. TR-81-208.

The Company also asserts that the provision of inside wire has become competitive. Since January 15, 1982, standard residence and business customers can utilize existing equipment at existing locations, can wire premises themselves after obtaining the needed materials from the Company or another vendor, or can hire someone other than the Company to wire the premises. Since 86 percent of the residences served by the Company are modularized, customers can also avoid any station handling charge by picking up their sets at a PhoneCenter store (or purchasing them from another vendor) and plugging them into the modular jacks themselves. Products are also now available at the PhoneCenter stores and from other vendors which allow a customer to modularize and wire his own premises if such work is necessary.

The Company asserts that if service connection charges are not set at levels equal to cost, then customers who elect to do their own installation work would be denied the opportunity to save the full cost of their work. Further, such customers would then be required to pay through higher monthly rates some portion of the costs caused by other customers who had the Company perform such work at rates which did not recover the full cost. Finally, Company asserts, service connection rates set at levels below cost would give the Company a competitive advantage over other vendors and contractors.

The Company also asserts that, from an economic standpoint, the only benefit and revenues which actually flow to the Company as a result of the installation of inside wire are the specific service connection charges associated with that installation. In support of this argument, the Company points out that it is not necessary for the Company to install inside wire to realize future revenues from a customer since the Company will receive revenues for any services it provides to the customer (i.e., access line, telephone sets, custom calling services, toll service, etc.) whether the Company installs the wire or the customer installs his own wire or pays another contractor to do it. Thus, in the Company's view, the revenues which the Company receives when it performs service connection functions represent the only true economic benefit received by the Company for such a service. While the physical life of the inside wire itself may be more than one year, according to the Company's argument, the economic life of inside wire is simply the amount of time necessary to install the wire and collect a charge for that installation.

Company argues that since the provision of inside wire is now a competitive market, continuing to capitalize station connections will give customers the "wrong economic signals". The Company also expresses concern that without ESC it will have a problem recovering the embedded costs in Account 232, which are continuing to grow largely because of moves, changes, rearrangements and the addition of extensions by new customers, not because of the addition of new subscribers. The Staff points out,

however, that Account 232 is still under the jurisdiction of the Commission and will continue to be so after Computer Inquiry II and AT&T divestiture are implemented.

The Staff continues to oppose the expensing of station connections-inside wire in this case. Staff believes that the Commission's reasoning in rejecting ESC in Case No. TR-81-208 is still valid. The Staff believes that the material and labor associated with the installation of inside wire create tangible assets of lasting value which can be located, added to, removed and reused by succeeding customers. Inside wire has a composite average service life of approximately four years.

Staff points out that the installation of inside wire is the connecting link between the telephone apparatus and the distribution lines to the central office. All three elements are required in order for the customer to use his telephone, thereby generating revenues for Southwestern Bell. The distribution lines and the station apparatus are capitalized by Southwestern Bell, but SWB seeks to expense the inside wire portion of station connections in this case. However, Company points out that it charges its customers a monthly recurring rate for any Company telephone set they utilize, and for access line facilities, but not for inside wire.

Staff states that even if customers who choose an alternative provider of inside wire will partially pay for other customers' Company-provided wire through recurring charges, this does not create an inequity of such magnitude as to override proper accounting treatment of station connections. The addition of a main station and the continued availability of that station when there is a reconnection is a benefit to the system as a whole, in Staff's view, and a benefit to other customers on the system.

The Staff disputes the Company's argument that the "economic life" or benefit to the Company from the provision of inside wire is solely the recovery of a service connection charge. First, Staff asserts that the tariff charges for station connections are not, and may never be, fully compensatory. Secondly, Staff argues

that there is a clear, direct and continuing economic benefit to the Company from the initial installation, connection, reconnection or reinstallation of inside wire, by giving access to the system which generates revenues for Southwestern Bell through telephone usage. The Staff alleges that the Company's proposed definition of "economic life" is designed solely to suit Southwestern Bell's own purposes on this issue, and that the true economic life of station connections-inside wire is the composite average service life of approximately four years.

While the capitalization of station connections-inside wire may originally have been designed, at least in part, to encourage universal telephone service by spreading the costs of such connections over all ratepayers and over a period of years, universal telephone service has largely been achieved and the monopoly environment in which service connections were formerly made has dramatically changed. Approximately 95 percent of Missouri households have telephone service, and the number of main stations in Missouri actually declined during the first half of 1982. During 1981, the Company had to install 16 stations in order to achieve a net gain of one station (16 to 1 churn ratio). Thus, although there is no growth occurring on the Missouri network, Account 232 is continuing to grow (deferring additional costs to future customers) because of moves, changes, rearrangements and extension telephone additions occurring among existing customers. The increased competition for the sale of inside wire and the increasingly compensatory level of service connection charges also signal significant changes from the environment in which the capitalization of station connection costs began.

The Commission determines that the Company's proposal for phasing in the expensing of the inside wire portion of station connection costs should be approved. Although the physical life of inside wire generally exceeds one year, station connection costs include the costs of labor associated with installation, reinstallation and reconnection of station apparatus as well as the cost of the wire itself. Continued capitalization of these service connections would require future

ratepayers to bear costs associated with service connections of other past and present ratepayers, even though a majority of service orders no longer require a premises visit by a Company installation technician and, in at least 72.3 percent of the residential installations in the test year, no inside wire was placed by the Company. Eighty-six percent of the residences served by the Company are modularized, and customers may also purchase products on the market with which to modularize and wire their own premises if such work is necessary. Since January 15, 1982, the provision of inside wire has become competitive. Upon these facts, the Commission concludes that the expensing of station connections-inside wire will allow customers to pay only for those costs which they actually cause the Company to incur, and will not require customers to pay higher monthly rates in order to cover the costs associated with another customer's choices or actions concerning service connections.

The Commission determines that it can no longer accept the distinction between accounting treatment of station connections-inside wire, and the rate design treatment to be afforded such station connections. Put simply, the continuation of the capitalization of station connections-inside wire discriminates against those customers who pay compensatory service connection charges or who perform the work themselves, and prevents such customers from realizing the full economic value associated with their available options.

The Commission notes that since it appears that there will be an additional revenue requirement for this Company during the next year, the Company should propose, in its next rate case, service connection charges that are fully compensatory.

The Commission finds and concludes that the Company's proposal should be adopted.

B. Straight Line Equal Life Group and Remaining Life Depreciation

In its prefiled testimony in this case, the Staff opposed the use of the Straight Line Equal Life Group (SLELG) depreciation procedure and the Straight Line Remaining Life (SLRL) depreciation technique for purposes of determining the appropriate level of depreciation expense in this case, unless and until the Commission approved either or both procedures in P.S.C. Case No. TO-82-3. On September 17, 1982, the Commission issued its Report and Order in Case No. TO-82-3 approving the use of the SLELG procedure and the SLRL technique and, as a result, authorizing Southwestern Bell to file tariffs to recover a \$12,000,000 revenue deficiency. After the Commission's decision in Case No. TO-82-3, the Staff joined the Company in recommending the use of SLELG and SLRL for purposes of determining depreciation expense in this case. (Hearing Memorandum, Joint Exhibit No. 3).

Public Counsel opposes the adoption of SLELG and SLRL, and proposes instead the continued use of the Straight Line Vintage Group method of depreciation. By stipulation of the Company and Public Counsel, the record of P.S.C. Case No. TO-82-3 was offered and received in evidence in the instant case. (Exhibit No. 225, consisting of seven volumes lettered A through G). The positions of the parties, including Southwestern Bell and the Public Counsel, are set out there.

On December 28, 1982, the Commission denied Public Counsel's Motion For Rehearing in Case No. TO-82-3. Nothing in the record of the instant case requires a different result. The Company is authorized to use SLELG and SLRL for purposes of determining depreciation expense in this case, consistent with the Commission's Report and Order in Case No. TO-82-3.

XII. Hotel and Motel Commissions

Staff, Company and Public Counsel have agreed that Company's test year expenses should be reduced by \$1,269,000 due to Company's proposal in this case to eliminate commission payments to hotels and motels for intrastate toll calls placed

by hotel and motel guest patrons. All parties agree that should the Commission reject Company's proposal to eliminate such payments, then Company's test year expenses and revenue requirement would increase by \$1,269,000.

Since the Commission is accepting Company's proposal to eliminate the hotel and motel toll commissions (see Section XIV.B.9 of this Report and Order, below), this \$1,269,000 adjustment in test year expenses is not necessary.

#### XIII. Revenue Requirement

Based upon the determinations of the Commission herein, Southwestern Bell's total net operating income requirement is \$180,218,000. The net operating income available for purposes of this proceeding is \$144,451,000, leaving a net operating income deficiency of \$35,767,000. After applying a factor for income tax and adding the amount related to uncollectable revenue gross-up, Independent Company Settlements, and deducting the additional revenue requirement resulting from the Commission's decision in Case No. TO-82-3 (see Section XI.B), Southwestern Bell's gross revenue deficiency in this proceeding is found to be \$63,771,000.

#### XIV. Rate Design

##### A. P.S.C. Case No. 18,309

In its Report and Order in P.S.C. Case No. 18,309, Re: Cost of Service Study of Southwestern Bell Telephone Company, issued May 27, 1977, the Commission established a framework for future cost and rate determinations for Southwestern Bell in Missouri. The Commission recognized three basic categories of service provided by the Company. Category One services are all services which are subject to substantial competitive pressure (e.g., business and residential vertical offerings, radio signaling, mobile services and data terminals). Category Two services are all those which are classed as basic telephone service (e.g., basic exchange service, and Outside Base Rate Area (OBRA) mileage). Category Three services include the balance of all services provided by the Company (e.g., residential vertical offerings which are not presently subject to substantial competitive pressure but which may be very competitive in a few years).

In Case No. 18,309, the Commission determined that Category One services should 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 long run incremental analysis (LRIA). The Commission stated that a price would 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. The Commission further stated in that case that Category Two services would be priced residually after taking into consideration any contribution to revenue requirement made by Category One and Category Three services. Category Three services were to be priced using LRIA as a foundation, and adjusting for social or economic factors related to the provision or receipt of those services. The Company, it was determined, had the initial responsibility of bringing forth any social or economic factors which should be taken into consideration in adjusting the LRIA price for Category Three services, and in adjusting the relationship between the charges for various Category Two services. The Company was ordered to perform an exchange class of service (ECS) cost study which developed the embedded direct cost for all classes of service under Category Two. The Commission stated that the relationships between those embedded direct costs should serve as the basic relationship in pricing Category Two services under the residual technique; that the basic price relationships may be modified to recognize specific social or economic factors attendant to the provision or receipt of those basic services; and that statewide average ratemaking should be retained as a pricing principle. The Company was expected to "move with deliberate speed" toward the implementation of the pricing plan established in Case No. 18,309.

The Commission's decision in Case No. 18,309 forms the basic framework of the rate design proposals of the Company and the Staff in this case.

Public Counsel, the State and the Missouri Alarm Association all recommend in this case that the Commission reconsider the approach established in Case No. 18,309. Public Counsel alleges that the underlying assumption of the

Commission's decision in that case was that incremental unit costs will always be higher than actual or embedded costs, and that this assumption has proven erroneous. Public Counsel proposes the use of a category cost of service study for rate design purposes in this case, using the Company's Embedded Direct Analysis (EDA) as a starting point, in lieu of reliance upon Company LRIA. Public Counsel's proposal is discussed in more detail below, particularly under Section XIV.B.18, "Category Cost of Service Study".

Missouri Alarm Association and the State are also highly critical of the approach established by Case No. 18,309 and, in particular, of the incremental unit cost (IUC) studies used by the Company in its LRIA for purposes of pricing private line services in this case. The Alarm Association's position and proposal is discussed more fully below in Section XIV.B.10, "Private Lines/OCC"; and those of the State are discussed particularly in Sections XIV.B.3, "Centrex C.O."; B.6, "WATS Restructure; Resale and Sharing of WATS Services"; and B.10, "Private Lines/OCC".

The Commission believes the evidence and argument presented by Public Counsel, Missouri Alarm Association and the State questioning the continued efficacy of the costing and rate design framework established by Case No. 18,309, merit the Commission ordering the Company to present a fully allocated embedded cost study in its next general rate case, in addition to LRIA. The parties are encouraged to present any other alternative costing methodologies which they believe should be used by this Commission in setting rates. This determination is discussed in more detail below at Section XIV.B.18, "Category Cost of Service Study".

B. Specific Rate Design Issues

1. Directory Assistance

Company currently does not charge customers for the first five directory assistance calls per month. For directory assistance calls in excess of the five-call allowance, Company charges customers 20 cents per call. Company has proposed in this case a restructuring of directory assistance charges as follows:

<u>Calls</u>	<u>Charge Per Call</u>
0 through 5	No Charge
6 through 10	25 cents
11 through 17	30 cents
18 and over	35 cents

Company's proposal would increase annual revenues by \$3,522,000. In its prefiled testimony, Company also discusses an alternative directory assistance charging proposal by which customers would be charged 25 cents for each call in excess of the five-call allowance. This alternative plan would increase annual revenues by \$2,785,700.

The Staff recommends rejection of the Company's proposed plan to increase charges for directory assistance calls in graduated steps which apply higher charges to those who make more calls. Staff contends that the Company has provided no data to support such a price structure and that the graduated plan would lead to additional administrative burdens not associated with flat rate plans. Staff also recommends rejection of the Company's alternative plan of charging 25 cents per call in excess of the five-call allowance.

The Staff recommends instead that the Company charge 30 cents per directory assistance call in excess of the monthly five-call allowance. Staff's plan would increase annual revenues by \$3,755,700.

Under the present directory assistance plan, customers with physical, visual, mental or reading handicaps receive directory assistance free of charge, regardless of how many directory assistance calls they place. Neither Company nor Staff has proposed any change to this aspect of directory assistance.

Eighty-seven percent of Southwestern Bell's customers will be covered by the five-call allowance and will not incur directory assistance charges. An additional 7 percent of Southwestern Bell's customers make between six and ten directory assistance calls per month. Three percent of the customers make 11 to 17 calls per month, and 3 percent make 18 or more calls per month to directory

assistance. The approximate embedded direct cost for a local directory assistance call was 24.53 cents in 1980 and 25.70 cents in 1981.

The five-call allowance is basically intended to allow for those instances in which new telephone listings or changed listings are not available in the current telephone directory published by Southwestern Bell. Staff asserts that no one can reasonably claim that directory assistance calls in excess of five per month constitute a basic telephone service, since the published directories are generally available. Thus, Staff urges that the charges for directory assistance calls in excess of the five-call allowance should be set so as to recover costs and provide a contribution to joint and common costs and to basic services. Staff's proposed directory assistance charges would accomplish this result.

While supporting implementation of its graduated plan, Company does not object to implementation of its alternative plan or of Staff's plan.

The Commission determines that the Company's proposed graduated plan for directory assistance charges would create unnecessary administrative burdens and could cause customer confusion. Further, the proposed graduated plan would keep the sixth through tenth directory assistance calls per month at 25 cents per call, which is below the Company's cost. The Commission also determines that the Company's proposed alternative plan of charging a flat rate of 25 cents per directory assistance call in excess of five calls per month is unacceptable because it would entirely fail to recover the Company's cost.

The Commission concludes that the Staff's proposed directory assistance charges should be accepted. Staff's plan maintains the five call per month allowance, which is adequate to meet the directory assistance needs of 87 percent of the Company's customers. Staff's plan also assures that the Company will recoup its costs of providing directory assistance service for all calls in excess of five per month, and will provide some contribution above those costs. Staff's plan is adopted.

2. 25-cent Coin Phone Calls

Company originally proposed in this case to increase the current 20 cents per call rate for a coin call to 25 cents. However, at the hearing of this case, the Company withdrew this proposal.

3. Centrex C.O.

The Company proposes to restructure and reprice Centrex Central Office (Centrex C.O.) service. Company's proposal is designed to relate Centrex C.O. rates more directly to the costs of providing such service, as determined by a C.O. Centrex cost study performed by the Company. Company's proposed rates are 25 percent above the costs identified in Company's incremental unit cost (IUC) studies. The revenue effect of Company's proposal is \$6,138,000, representing approximately a 35 percent increase in Centrex C.O. station line rates.

The Staff was critical of the IUC studies with which the Company supported its Centrex C.O. rate proposal, because those IUC studies did not account for inflation as did other Company IUC studies supporting rates in this case. In response to Staff's criticism, the Company presented in evidence a revised IUC study on Centrex C.O. rates which accounted for inflation in a manner consistent with the methodology approved by the Staff. The Staff recommends that the Commission set Centrex C.O. rates based on the revised IUC study. This proposal would have a revenue effect of \$6,340,700. Staff does not oppose Company's proposal to restructure Centrex C.O. service.

Public Counsel also supports Company's proposal to restructure and reprice Centrex C.O. service. However, Public Counsel would prefer to see Centrex C.O. rates increased only to a level equal to the costs indicated in Company's cost studies, rather than to a level 25 percent above such costs as proposed by Company.

The State of Missouri opposes Company's Centrex C.O. proposals because they will result in rate increases to the State and the State's current budget plans do not contemplate or take such an increase into account. The State is critical of the

Company's proposal to eliminate the current declining block rate schedule for Centrex C.O. customers, under which larger Centrex customers receive lower rates depending on how many stations are associated with their Centrex system. The State alleges that the current declining block rate structure recognizes certain economies of scale in providing large Centrex systems and that, under the proposed restructure, such economies will be ignored. However, the IUC studies supporting the Company's proposals relating to Centrex C.O. reflect no measurable economies of scale in the provision of Centrex C.O. service by the Company. The State also alleges certain defects in the Company's IUC studies relating to Centrex C.O. The Commission has considered the evidence and arguments concerning these alleged defects, and finds that the State's allegations are without merit.

The Commission finds that the Company's proposed restructuring of Centrex C.O. is reasonable. The Commission further finds that the appropriate rates for such revised Centrex C.O. service should be 25 percent above costs based upon the revised IUC study which accounts for inflation, in accordance with the Staff's recommendation.

#### 4. Direct Inward Dialing

The Company proposes to eliminate one of two alternate payment plans currently available for direct inward dialing (DID) service. The result will be that all customers will receive DID service under the rate plan approved by the Commission in Case No. TR-80-256. While no change of rates is proposed for DID service under the remaining plan, customers changed from the eliminated plan to the remaining plan would, in most cases, experience an increase in monthly rates. The revenue effect of the proposal is \$1,230,000. Staff does not oppose Company's DID proposal, and Public Counsel has included Company's proposal in Public Counsel's proposed rate design package in this case.

The Commission finds that the Company's DID proposal is reasonable and should be approved.

#### 5. Directory Listings - Schedules

The Company proposes to eliminate differentials which exist among the different exchange rate groups for extra listings, alternate listings, joint user listings and rotary number group listings. As a result of the Company's proposal, all customers would pay the same rate for a particular listing. The revenue effect of the proposal is \$138,700. Staff does not oppose the Company's proposal, and the Public Counsel has included Company's proposal in Public Counsel's proposed rate design package in this case.

The Commission finds that this proposal of the Company is reasonable and should be approved.

#### 6. WATS Restructure; Resale and Sharing of WATS Services

The Company proposes to reprice and restructure WATS service to eliminate flat rate WATS service and to make the WATS service offering more usage-sensitive. The Staff does not oppose the proposed restructure of WATS rates, if the Commission also authorizes resale and sharing of WATS service as a part of this case. Resale and sharing of interstate WATS is already permitted by the Federal Communications Commission (FCC). The Company has no objection to the resale and sharing of intrastate WATS as part of this case if its proposed restructure is approved.

Public Counsel supports the Company's proposed WATS restructure, and supports the proposal to allow resale and sharing of WATS. In the Rate Design Hearing Memorandum in this case (Joint Exhibit No. 4), Public Counsel stated his opposition to any restructuring of WATS rates which results in a decrease in revenues derived from WATS service. In fact, the Company's restructuring proposal would have a negative revenue impact of \$1,642,400. However, Public Counsel has included the Company's WATS restructure proposal in Public Counsel's proposed rate design package in this case.

The State of Missouri opposes the restructure of WATS and the increases it would experience as a result of the proposed restructuring. The Company's

proposal would result in large increases in the State's WATS rates. The State also maintains that resale and sharing of WATS services would not be beneficial to the State.

At the present time, both inward and outward WATS service is available on three different flat rate bases. The three rate offerings provide 173 hours, 50 hours and 10 hours of usage, respectively, for a basic flat rate, and then charge on a per-hour basis for usage in excess of the base allowance. Under the present plan, inward and outward WATS services are billed at the same rate.

The Company's proposed restructure in this case would establish separate access line rates for 800 service (inward WATS) and for outward WATS, and establish a sliding (declining) scale of charges for all hours of usage. The Company's proposal would also introduce discounts for usage in the evening, night and weekend periods. The usage charges would make WATS rates more usage-sensitive than existing rates. The Company's proposed rates are based on incremental cost studies for WATS access lines as well as WATS usage, and cost studies on WATS nonrecurring charges. The proposed restructure will result in some customers paying more for their service than they are presently paying and some customers paying less. The impact on customers will vary depending upon their actual usage and the time of day and day of week of such usage. Generally, WATS customers with 50 or more hours of usage per month will experience rate increases as a result of the proposed WATS restructuring.

Company's proposed WATS access line rates are directly derived from the incremental costs. The proposed usage rates, as filed by Company, are structured in four rate groups, similar to interstate WATS, and were designed to effect no change in current revenues for either inward or outward WATS. Supplemental testimony indicated that there would be a \$1,642,400 decrease in revenues.

The Commission determines that the Company's proposed restructuring of WATS rates, as revised, should be approved, and that the Staff's recommendation that resale and sharing of WATS service be authorized should also be approved. The

Commission finds and concludes, based upon the IUC studies and nonrecurring cost study utilized by the Company, that the proposed restructuring of rates is just and reasonable. Further, the ability to resell and share WATS services will make intrastate WATS services consistent with interstate WATS services. The evidence is clear that a significant differential between WATS and toll rates will continue to exist, contrary to the State's asserted concern that the Company will somehow reduce toll rates while increasing WATS rates in order to squeeze WATS resellers out of the market. While the impact of the WATS rate restructure upon large users may be significant, the placement of WATS rates on a cost-based, usage-sensitive basis is clearly just and reasonable.

7. Centrex C.U./Package PBX

The Company proposes to restructure these obsolete service offerings by changing from a packaged, to an item-by-item method of billing. The Company's proposal will not increase overall revenues. Under the Company's proposal, some customers of these services will experience rate increases and others rate decreases, as customers will be charged according to the level of services and equipment which they receive. Company states that this change is appropriate in response to the Federal Communications Commission's decision in Computer Inquiry II, which will require the Company to separate charges for equipment located on customers' premises from all other charges. Under the proposed restructure, customers will be billed separately for all services and equipment, except the common equipment and the attendant positions.

The Staff does not oppose the Company's proposal on this issue, as modified in the Company's supplemental testimony (Exhibit No. 25, pp. 7 and 8 and Schedule Nos. 1 and 2). Public Counsel has included the Company's proposal on this issue in Public Counsel's proposed rate design package in this case.

The Commission finds that the Company's proposal, as modified in Company's supplemental testimony in this case, is reasonable and should be approved.

#### 8. Local Conference Calling

Company proposes to restructure its current rates for this service by charging a set-up charge for each exchange access arrangement (EAA) and a per-minute charge for usage. Currently, customers are charged a set-up charge for each group of five customers on the conference, and a usage charge of 6 cents per minute, per EAA. The restructure is based upon a Company cost study, and the usage schedule will be identical to the LMS usage schedule. Since set-up charges would increase under the Company's proposal, while usage charges decrease, the proposed restructure would be accomplished at a revenue impact of only a negative \$200.

The Staff does not oppose the Company's proposal on this issue. Public Counsel has included the Company's proposed restructuring in his recommended rate design package in this case.

The Commission finds that the Company's proposal is reasonable and should be approved.

#### 9. Hotel/Motel Station Line Rates and Toll Commissions

The Company proposes to eliminate the existing five-cent differential between the rate for hotel/motel guest station lines and the rate for station lines provided to all other PBX customers. The Company bases its proposal upon its opinion, joined in by the Public Counsel and the Staff, that there is no cost justification for such a rate differential. The differential in question was reduced from 20 cents to 5 cents in the Company's last general rate case (Case No. TR-81-208). The Missouri Hotel and Motel Association opposes the proposal.

The Company also proposes to eliminate, effective January 1, 1983, the payment of 15 percent commissions to hotels and motels on certain intrastate toll calls placed by hotel and motel guests from their rooms. Interstate toll commissions are scheduled to terminate on the same date. In conjunction with this proposal, the Company further proposes to eliminate resale and sharing restrictions on intrastate toll services so that hotels and motels will be able to recover directly from the

guests placing toll calls any costs incurred in facilitating such calls. Public Counsel also supports this proposal of the Company. The Missouri Hotel and Motel Association opposes the elimination of the intrastate toll commissions, though favoring the proposal to eliminate restrictions on resale and sharing of telephone service.

The Company, Staff, Public Counsel and Missouri Hotel and Motel Association agree that if the toll commissions are not eliminated, Company's revenue requirement in this case should be increased by \$1,269,000.

The Missouri Hotel and Motel Association asserts that the toll commissions, which have been paid to hotels and motels by telephone companies for over 35 years, are actually compensation for services provided by hotels and motels to the telephone companies. Such services, it is alleged, include accounting for guest telephone calls, generating billing records for such calls, billing customers and collecting charges for long distance calls and remitting those charges to the telephone company, providing certain types of operator assistance to hotel guests in the placement of their calls, rating guests' credit and, in effect, accepting responsibility for payment of guests' telephone charges, and providing adequate equipment (including trunk lines and switching equipment) to hotel guests so that the long distance facilities of the telephone company can be accessed. The Hotel and Motel Association asserts that hotels and motels should at least be entitled to the same commission on toll calls from guest room phones as are received by businesses for toll calls from pay telephones placed on the premises of such businesses, which is 10 percent.

However, the Company asserts that commissions paid for coin telephones are essentially in the nature of "rent" for the space utilized by such coin phones. The Company asserts that the "services" alleged by the Association to be performed by hotels and motels on behalf of the Company are, in fact, generated on behalf of and for the convenience of hotel and motel guest-patrons.

The Commission finds that there is no cost justification for the existing 5-cent differential between the hotel and motel station line rate and the rates for station lines provided to all other PBX customers. Therefore, the Commission concludes that the Company's proposal to eliminate that differential should be approved.

The Commission further finds that the Company's proposal to eliminate commissions to hotels and motels on intrastate toll calls, and to eliminate resale and sharing restrictions on intrastate toll service, is just and reasonable and should be approved. The continuation of such commissions would require the general body of ratepayers to bear the costs of the hotels and motels in providing telephone-related services to their guests. The costs of those services should be borne by the hotel and motel guests who require those services. The elimination of restrictions on resale and sharing of intrastate toll services will give hotels and motels the ability to recover their costs of providing such services, without imposing those costs on the general ratepayer.

#### 10. Private Lines/OCC

The Company proposes rate increases throughout its private line tariff for both recurring and nonrecurring charges. Rates for recurring charges have been proposed on the basis of a long run incremental analysis (LRIA). Company also proposes increases in recurring and nonrecurring rates for Other Common Carriers (OCCs). In addition, the Company opposes the removal of tariff restrictions on the resale and sharing of private line services until such time as all private line rates equal or exceed incremental cost. The Company opposes the resale and sharing of private line services for use in the provision of MTS (toll) or WATS-like service offerings.

Because the Company considers private line service to be a Category Three service within the meaning of the Commission's Report and Order in Case No. 18,309, Company has not proposed to implement those rates which the LRIA study indicated

would produce the largest practical level of contribution from private line services. Due to customer impact considerations, Company followed the following guidelines in proposing private line rates in this case:

1. Bring all services below costs up to cost with the exception of the intraexchange less-than-a-mile offerings, the rates for which are proposed at roughly one-half of the indicated full rate.
2. Increase all services already exceeding cost, including intraexchange services, by 15 percent.
3. Set nonrecurring service charges at 25 percent of the identified cost levels.

While the Commission Staff believes that the private line LRIA filed by the Company in this case is superior to the one considered by the Commission in P.S.C. Case No. TR-78-235 and believes that the Company's private line LRIA is a reliable study upon which the Commission can establish rates, neither the Staff nor any other party concurred completely in Company's proposals concerning private line services in this case. The State of Missouri opposes the proposed increases in recurring and nonrecurring charges for private line, both intraexchange and interexchange. Public Counsel and Missouri Alarm Association also oppose Company's proposed private line rates, as discussed in detail below.

The Staff disagrees with the Company's proposed charges for recurring private line rates and recommends that the recurring rates should move forward, providing a uniform contribution above the costs determined by the Company's LRIA. The Staff believes that private line rates should at least recover all costs identified in the LRIA, and preferably provide a contribution above cost in the range of 5 to 15 percent.

For purposes of clarity, this issue will be subdivided into five parts:

- (a) OCC, (b) Nonrecurring Private Line, (c) Interexchange Private Line,
- (d) Intraexchange Private Line, and (e) Private Line Resale and Sharing.

(a) OCC

No party opposes the Company's proposed recurring or nonrecurring rates for OCC facilities. The additional revenues associated with Company's OCC proposals is only \$3,000.

The Commission finds that the Company's proposal for recurring and nonrecurring rates for OCC facilities is reasonable, and it is hereby approved.

(b) Nonrecurring Private Line

This subissue relates to the Company's rate proposals for installation activities associated with private line services. Although the Staff was critical of the Company's nonrecurring cost study, it did not object to the proposed rates, which are set at 25 percent of the costs identified in the Company's study. The Company proposal is assertedly designed to prevent "a significant adverse financial impact upon [the Company's] private line customers." The proposed increase is designed by the Company to be the first step in "an orderly progression of increases until full cost recovery is achieved." The Company's proposal would result in percentage increases ranging from 110 percent to 407 percent. The percentage increases for the same services, had they been proposed at cost based on the Company's cost study, would have ranged from 690 percent to 1913 percent.

The Company's cost study on nonrecurring private line rates used a panel of estimators technique. The Network C.O. portion of the study used eight people to estimate minimum, maximum and average labor times in minutes. For six of the eight estimators in the Network C.O. study, a comparison of estimates between the categories reveals that they always, or almost always, show the exact same number of minutes. For this reason, Staff and Public Counsel question the reliability of the study. Staff, nonetheless, believes that setting private line nonrecurring rates at 25 percent of the Company's identified costs is reasonable, because such a figure, in Staff's opinion, would not be above actual costs. Staff does not believe, however, that one could be confident as to whether the rates would be above or below costs if one moved further above the 25 percent figure.

Public Counsel, on the other hand, recommends that nonrecurring private line charges be set at 50 percent of the costs identified by the Company. Public Counsel is critical of the Company's proposal that nonrecurring charges be "eased" toward actual costs step-by-step, since Public Counsel believes that the Commission should require that nonrecurring charges be set at the actual cost of providing service. Public Counsel observes that existing customers are not affected by changes in nonrecurring charges; and that nonrecurring charges for basic exchange customers are set at the Company's identified costs as a result of the Commission's decision in Case No. TR-82-14. Public Counsel asserts that basic exchange ratepayers should not be required to pay the full cost of installations while private line customers receive rates substantially below cost. However, since the Public Counsel agrees with the Staff that the Company's nonrecurring private line cost study cannot be relied upon, Public Counsel recommends that those nonrecurring private line charges be set at 50 percent of the costs identified by the Company's study.

The Missouri Alarm Association also alleges that the Company's nonrecurring cost studies overstate the nonrecurring costs actually experienced by the Company by using unrealistic time estimates multiplied by "loaded" labor rates "inflated to astronomical levels", and by not including in its time studies "state-of-the-art technology" which reduces the Company's costs. The Alarm Association's witness also testified that the Alarm Association would not oppose the setting of nonrecurring private line charges at 50 percent of the costs identified by the Company's study.

The Commission finds and concludes that Public Counsel's recommendation is just and reasonable and should be approved. As a result, nonrecurring private line charges shall be set at 50 percent of the costs identified by the Company in its study.

(c) Interexchange Private Line

Public Counsel supports the Company's proposal to increase interexchange private line recurring charges, although asserting that the costs of such services

would be more properly measured through the use of an embedded cost study. Public Counsel urges the Commission to direct the Company to perform such a study and states that, upon completion of the study, interexchange private line rates should be adjusted to recover the identified costs. Public Counsel believes that the embedded costs associated with interexchange private line services are higher than incremental costs.

The Missouri Alarm Association believes that the Company's proposals are designed to underprice interexchange private line service and to overprice intraexchange private line service. This allegation will be discussed more fully below under "Intraexchange Private Line Rates". The Missouri Alarm Association joins the Public Counsel in urging the Commission to direct the Company to perform embedded cost studies for private line services. The Alarm Association, in its brief, urges that any resulting revenue requirement attributable to private line services in this case be placed on interexchange private line channel rates, and that any revenue requirement resulting from the Alarm Association's proposed reduction of intraexchange private line services should also be placed on interexchange private line rates. The Alarm Association's witness, however, proposed that private line rates should be increased residually in this case if a revenue deficiency is determined.

For reasons set out more fully below (under "Intraexchange Private Line Rates"), the Commission finds and concludes that the Company did not adequately respond to the substantial criticisms concerning the Company's IUC studies. Therefore, the IUC studies utilized by the Company in support of its interexchange private line rates in this case should not be relied upon. However, neither the Company nor any other party submitted other cost studies upon which the Commission could base a decision with respect to the proper level of rates for interexchange private line recurring services. As a result, interexchange private line recurring rates will be increased on an equal percentage basis with other services after

certain rate adjustments. (See Section XIV.B.12, "Local Exchange/OBRA Mileage", and Section XIV.C, "Rate Design Summary").

In addition, the Company will include private line services in the fully allocated embedded cost study it will be directed to file in its next general rate case. (See Section XIV.B.18, "Category Cost of Service Study").

(d) Intraexchange Private Line Rates

As indicated previously, the Company is proposing to increase intraexchange private line rates by 15 percent, with the exception of intraexchange less-than-a-mile offerings, the rates for which are proposed at roughly one-half of the full cost indicated by the Company's LRIA. The Staff recommends that all recurring private line rates, including intraexchange, should provide a uniform contribution above the costs determined by the Company's LRIA.

Public Counsel and the Missouri Alarm Association oppose the Company's proposal to increase intraexchange private line rates. Both Public Counsel and the Alarm Association advocate the use of an embedded cost study for the pricing of intraexchange private line services.

The State of Missouri also opposes the proposed increase in intraexchange recurring charges. The State argues that private line services are not subject to substantial competition and, therefore, that a LRIA is an inappropriate basis for the establishment of private line rates. The Company does not assert that private line services are presently subject to "substantial" competition in Missouri. However, competition is currently developing in the Missouri private line market. The Commission has previously specifically rejected the suggestion that private line services be classified as a Category Two (basic) service, and has held that such services should be priced on the basis of a LRIA. P.S.C. Case No. 18,309; P.S.C. Case No. TR-78-235.

Public Counsel's asserted opposition to an increase in intraexchange private line rates in this case is not unequivocal. Public Counsel's witness stated

that intraexchange private line rates should be increased by the same percentage as local exchange service in this case. The witness for the Missouri Alarm Association also testified that if the Commission should determine that the Company has a revenue requirement deficiency in this case, and that it is necessary for private line users to contribute to this revenue requirement deficiency, the increase should be across the board in line with the overall increase granted to the Company. However, Missouri Alarm proposed a different allocation of Company's revenue requirement deficiency in this case in its brief, as explained below.

The Missouri Alarm Association alleges that the Company has manipulated the IUCs used in its private line LRIA study in order to continue to underprice interexchange private line services, which are competitive, and overprice intraexchange private line services, which are essentially monopolistic. The Company's motivation, according to the Alarm Association, is to encourage migration from intraexchange to interexchange services and cause a market reaction favorable to AT&T when deregulation occurs, enhancing AT&T terminal equipment marketing plans. The result of this "migration strategy", according to the Alarm Association, is the repression of demand for private line services, resulting in significant stranded investment and ultimately higher telephone rates for all Missouri customers because of the costs of unused plant.

Missouri Alarm Association is critical of the Company's cost study of loop lengths for not including OCC loops (bulk offerings utilized by private line users, including alarm companies), which are located within a mile of the serving office of the telephone company; by studying all loops as opposed to private line loops, thereby lengthening the average loop and increasing the necessary investment; and by overstating the necessary private line facilities by including "bridge tap" (that portion of wire which is not in the direct electrical path between the telephone company serving office and the customer's location) in the length of the loop. The Alarm Association (joined by the Public Counsel) further alleges that the Company

used an actual fill factor of 49 percent in its intraexchange IUC in order to manipulate costs upward, while using an "objective" or "optimal" fill factor of 85 percent in its interexchange study, in order to understate interexchange private line costs. The Alarm Association asserts that the use of the 49 percent fill factor in the intraexchange study requires the customer to pay for two loops constructed in the future, when he is actually using one loop constructed in the past. The Alarm Association further asserts that the Company's service area function (SAF) study, to determine the cost of providing transmission equipment for loop facilities, overstated actual SAF costs for private line customers because of the use of the weighted average loop length determined from the loop sample, and by including bridge tap in the weighted average loop length. The Alarm Association also alleges that the Company's cost studies do not consider technological advances in the types of facilities which can be used to provide private line services, which will act to reduce intraexchange private line costs.

In its brief, the Alarm Association recommends that private line intraexchange rates be reduced by 30 percent, asserting that this rate level will still place those rates above the embedded cost of intraexchange private line services and provide a contribution to the benefited services. MAA further recommends that any revenue requirement deficiency in this case found to be attributable to private line services be placed on interexchange private line channel rates, and that any revenue requirement reduction resulting from MAA's proposed reduction of intraexchange private line rates also be placed on interexchange private line rates.

As stated previously, Missouri Alarm Association and Public Counsel also urge that the Company's intraexchange and interexchange private line rates should be based on embedded cost studies, which Company should be directed to perform.

The Commission is persuaded by the evidence presented by the Alarm Association and the Public Counsel that the IUC studies performed by the Company in

support of its proposed interexchange and intraexchange private line rates in this case should not be relied upon. The Company failed to adequately respond to the substantial criticisms of the parties. Since no other cost study of private line services has been presented, the Commission finds and concludes that intraexchange private line recurring rates (as well as interexchange private line recurring rates, discussed above) should be increased on an equal percentage basis with other services after specific rate adjustments. (See Section XIV.B.12, "Local Exchange/OBRA Mileage", and Section XIV.C, "Rate Design Summary"). The Commission finds no evidence to support the Alarm Association's proposal (in its brief) that intraexchange private line rates be reduced by 30 percent.

In addition, the Company will include these private line services in the fully allocated cost study which the Company will be directed to file in its next general rate case. (See Section XIV.B.18, "Category Cost of Service Study").

(e) Private Line Resale and Sharing

Public Counsel proposes that the Company be required to allow the resale and sharing of its interexchange private line services. The Company opposes the removal of tariff restrictions on the resale and sharing of private line services until such time as all private line rates equal or exceed incremental costs. The Company further opposes the resale and sharing of private line services for use in the provision of MTS (toll) or WATS-like service offerings.

Public Counsel asserts that his proposal is designed to ensure that interexchange private line rates will move towards cost. As recited hereinabove, Public Counsel believes that the Company's cost studies substantially understate the Company's actual costs of providing interexchange private line service. Interstate private line services have been subject to resale and sharing for approximately four years. The FCC tariff which allows resale and sharing of private line services restricts against resale and sharing as a substitute for MTS/WATS services. Public Counsel does not object to the inclusion of such a restriction on resale and sharing of intrastate private line services.

The Commission finds and concludes that the Company should be required to allow the resale and sharing of its interexchange private line services, except for use in the provision of MTS or WATS-like service offerings.

11. General Exchange/Vertical Services/IUC Studies

The Company has filed the results of approximately 1700 IUC studies on such business vertical services as key telephone service, mobile telephone service, DIMENSION<sup>R</sup> PBX service, and HORIZON<sup>R</sup> service. The Company has generally proposed rate levels for these services which are 25 percent above incremental costs (including inflation). The major exceptions to the 25 percent contribution level, as set out and explained in Company testimony, are services for the disabled (priced at cost), some data terminal equipment (priced at 15 percent above incremental cost), and mobile services (priced at 10 percent above incremental cost).

The Staff found all of the IUC studies (with the exception of Centrex C.O. as discussed hereinabove) consistent with past IUC studies performed by this company. The Staff notes that the Company used avoidable cost studies, rather than IUC studies, for equipment which the Company was either proposing to make obsolete or had already made obsolete. The Staff found that the avoidable cost studies were inappropriate in some circumstances, particularly when the equipment it applied to had been recently installed. However, the Staff has no objection to the rates proposed based upon these studies, except for Centrex C.O. as previously discussed.

The Public Counsel advocates increasing IUC-supported services (and Centrex C.O., as discussed above) by the percentage overall increase granted to the Company in this proceeding. Public Counsel asserts that this approach would maintain current rate relationships pending the completion of what Public Counsel considers to be more appropriate cost studies, discussed further below under Section XIV.B.18, "Category Cost of Service Study".

Upon the record in this case, the Commission finds and concludes that the Company's proposal is reasonable and should be adopted. While the Commission is

entertaining questions as to the continued viability of IUC studies and the efficacy of the framework established by Case No. 18,309 (see Section XIV.B.18, "Category Cost of Service Study", below), the Commission cannot find upon the record of this case that the studies utilized by the Company for the pricing of these services should not be relied upon. Therefore, these services will be priced at the levels proposed by the Company in this case.

#### 12. Local Exchange/OBRA Mileage

The Company has proposed to recover its remaining or residual revenue requirement from local exchange services and Outside Base Rate Area (OBRA) charges. Company proposes to apply the increases to the local exchange category of services in such a way as to maintain the rate relationships demonstrated by the Company's exchange class of service (ECS) study and approved by the Commission in the Company's last three rate cases.

The Company is proposing to modify the current rate relationship between PBX flat rate trunks and flat rate business lines, and is proposing to establish rate relationships for all message rate services, including local measured service (LMS). Unlike the majority of the Company local exchange services which have had rate relationships established and approved by the Commission on the basis of the ECS study in previous cases, no relationships currently exist among four-party flat rate service, message rate services and LMS. Company believes that such relationships should be approved in this case regardless of the revenue requirement allocated to local exchange. The Company has proposed to accomplish its restructure of measured services and local exchange rate relationships at a revenue effect of \$1,611,100. The Staff supports this proposal with certain modifications which have been agreed to by the Company. Public Counsel also includes Company's proposal in Public Counsel's proposed rate design package in this case.

Staff recommended the elimination of the Company's present four-party mileage charge. Because four-party service is the lowest grade of service available,

Staff believes the concept of universal service supports the elimination of this charge. This proposal would have a negative revenue impact of \$486,200. Although originally proposing a residual increase of all OBRA mileage charges, the Company has now adopted the Staff's proposal to eliminate OBRA mileage charges related to four-party service, and has included the revenue effect of Staff's proposed change in its rate design package in this case.

Under the Company's original proposal, \$130,000 in increases to local exchange would have occurred as a result of the Company's proposal to reclassify four exchanges (Gideon, Malden, Risco and Marston) due to growth. However, a recent review of exchange access arrangements indicates that it would not be appropriate to reclassify those exchanges at this time and, therefore, the Company has withdrawn that proposal.

Further, under the Company's local exchange proposals, any revenue requirement in excess of approximately \$25,991,000 would be applied to local exchange services on a residual basis in such a way as to maintain the rate relationships approved for such services in prior cases. The Staff supports the Company's proposal with the understanding that any toll increases agreed to by the Company and the Staff in their stipulation on toll charges (see XIV.B.14, below) would also be implemented prior to any residual increases in local exchange services. Public Counsel also supports increases to local exchange services in a percentage equal to other services after certain rate adjustments, if the Company's revenue requirement is in excess of \$13,047,200 (the amount of Public Counsel's proposed rate package).

The Commission determines that the proposals agreed to by the Company and Staff on this issue are reasonable, and they are approved, except that the excess revenue requirement will be applied not only to local exchange services, but also to certain other services, on an equal percentage basis after certain specific rate adjustments. The Commission concludes in this case that local exchange rates should not be increased by an amount greater than this without the support of cost studies

showing that local exchange rates do not cover costs. For the same reason, the Commission is rejecting the stipulation of the Staff and Company concerning toll charges (Section XIV.B.14, "Toll", below). The application of equal percentage increases in this case is set out in more detail under Section XIV.C, "Rate Design Summary".

13. Unrecovered Telephone Equipment Charge (UTEC)

The Company proposes to apply a charge to those customers who disconnect service and fail to either return their telephone sets to the Company or fail to keep an appointment allowing the Company to pick up the sets. The proposal is based on a cost study, and the charge would vary depending on the type of telephone sets involved. The charge would be returned to the customer if the set is later recovered.

The Staff opposes implementation of an unrecovered telephone equipment charge. Staff believes that the Company has not provided sufficient or appropriate data to support its plan, and that the drawbacks of implementing any UTEC plan in Missouri outweigh any potential benefits. The Public Counsel supports the concept of a UTEC charge, but disagrees with Company's identified cost levels. Neither Staff nor Public Counsel offered an alternative proposed charge.

The Commission concludes that the Company's proposal is reasonable and should be approved. When the Company loses a telephone set, it incurs a cost which, without a UTEC, is passed on to the general body of ratepayers. The Company's proposal provides an additional incentive for customers who disconnect service to return leased phone sets to the Company. In the alternative, Company's plan allows for the assignment of costs for lost sets to the customer causing those costs.

The Company's proposal is approved.

14. Toll

The Company has proposed to eliminate the current tariff restrictions on the resale and sharing of toll service. While the Company initially proposed no increase in toll rates in this case, the Staff took the position that there should be an increase in toll rates if the Commission approved "a significant amount of additional revenue". During the hearing in this case, Staff and Company reached, and submitted to the Commission, a stipulation regarding toll increases for the purposes of this proceeding. No other party joined in the stipulation. The provisions of the stipulation are as follows:

For the purpose of TR-82-199, the Staff and Company agree that the following increase for toll service should be approved in conjunction with any revenue requirement found in this case:

<u>ULTIMATE AWARD</u>	<u>TOLL INCREASE</u>
Less than 30M [Million]	No Increase
More than 30M, less than 50M	\$ 1.0M
More than 50M, less than 75M	\$ 2.0M
More than 75M, less than 100M	\$ 4.0M
More than 100M, less than 125M	\$ 6.0M
More than 125M	\$ 8.0M

The toll increases above are in addition to the toll increase of \$2.9M which is to become effective in conjunction with Case No. TO-82-3. In addition, the proposed increase would be implemented without increasing any rates in the first four rate steps of the tariff toll schedule.

Public Counsel would include toll service among the services to be increased on an equal percentage basis with other services after certain specific rate adjustments.

The Commission cannot determine upon the record herein that the stipulation reached by the Company and the Staff is just and reasonable, absent cost studies which show that toll rates already adequately cover costs. Rather, the Commission concludes that toll rates should increase on an equal percentage basis with other services after certain specific rate adjustments. This would include the first four rate steps of the tariff toll schedule. The Commission further determines that the

Company's proposal to eliminate the current tariff restrictions on the resale and sharing of toll service is just and reasonable, and should be approved.

15. Exception Tariffs

The Company is proposing to change the way in which Missouri customers serviced by central office equipment located in other states are charged for local exchange service. Currently, such customers are charged the local exchange rates applicable in the serving exchange of the bordering state. The Company proposes that these customers should, in the future, be charged the applicable Missouri rates. This would eliminate the necessity of filing "exception tariffs" with the Commission, and is consistent with the manner in which these customers are charged for all other services.

The Staff opposes the Company's proposal to eliminate exception tariffs. Staff urges that the reasonable course is to maintain the status quo until the Modified Final Judgment (MFJ) is implemented, "so that one need not change the regulation twice."

The Commission determines that the Company has not met its burden of proving that its proposal is just and reasonable. Company's proposal is rejected.

16. Sale of Installed Base Equipment to Customers

The Public Counsel advocates the implementation of a program by the Company to sell its installed base equipment to customers. Such a program, it is urged, would increase competition in the customer premises equipment (CPE) market and benefit both Southwestern Bell and its customers. The Company opposes Public Counsel's suggestion. The Staff did not take a position on this issue.

Public Counsel asserts that the sale in place of installed base equipment at or above net book costs will keep the Company whole and avoid the effect of stranded rate base on basic exchange ratepayers. "Stranded rate base" is plant which has not been fully depreciated but which is no longer used by customers for service. The investment continues to generate a return requirement, but does not generate any

revenue. Public Counsel asserts that, as the Company loses equipment lease customers as a result of sales of CPE by Southwestern Bell's competitors, the stranded equipment problem will grow. If current lease customers purchase installed CPE, however, the loss of those customers will not result in a burden on residually priced monopoly services.

In conjunction with this proposal, Public Counsel also proposes that the Company should be required to disaggregate its charges on monthly bills to show monthly CPE charges separately from other charges. This proposal, which was set out separately by the parties in the Rate Design Hearing Memorandum in this case (Joint Exhibit No. 4), is discussed below under Section XIV.B.19, "Customer Billing".

The Company is not opposed, in principle, to the Public Counsel's proposal concerning sale of installed base equipment, nor to a review of this question with the Commission, its Staff and the Public Counsel. However, the Company asserts that it has not yet finalized any plan of action for Missouri operations concerning the complex legal, regulatory and marketing issues which of necessity would be involved in such a sale plan. Company avers that there is an insufficient record in the context of this case for the basing of a meaningful decision on the question of sale of installed base equipment.

While agreeing with the Company that the record before it is insufficient to support a directive that the Company implement sales of installed base equipment, the Commission nonetheless believes that Public Counsel has raised meritorious considerations on this subject which deserve concentrated attention. The Commission will, therefore, establish a new docket on this subject and direct the Company to report to the Commission, within 10 days of the effective date of this Report and Order, the Company's plans concerning the sale of installed base equipment. After such a report is filed, any other interested party may file responses to the Company's report.

17. "Tier A" Charges For Terminal Equipment

The Public Counsel advocates increasing "Tier A" charges for terminal equipment to levels reflecting current capital costs. The Company and the Staff oppose Public Counsel's suggestion.

Under Two-Tier contracts, customers have the option of choosing to spread the payment of capital-related charges associated with their terminal equipment over a selected payment period. During the contract period, such customers pay two rate elements: a fixed "Tier A" rate which recovers capital costs (including depreciation, cost of money and income taxes) evenly over the life of the contract, and a variable "Tier B" rate which recovers the Company's ongoing operating costs associated with the provision of the service. The Tier A portion of the Two-Tier payment plan cannot be changed by the Company during the contractual term. At the end of the selected contract period, the Tier A charge ceases and the customer may continue service by paying only the Tier B rate. Whenever costs are updated concerning equipment offered under the Two-Tier plan, the Tier B rate is adjusted to reflect changes in operating expenses. If the cost study indicates changes in the Tier A portion of the Two-Tier rates should be made, such changes are made applicable only to new customers.

The Public Counsel asserts that the fixed nature of Tier A rates results in discriminatory pricing and assists the Company in the implementation of its "migration strategy" [discussed hereinabove under "Private Lines/OCC", Section XIV.B.10(d)]. Two-Tier contracts are available for private branch exchange (PBX) equipment, as well as for other services used by some business customers, but not for any products or services used by residential customers. Public Counsel asserts that since customers who receive service under Two-Tier agreements are able to fix "a large portion of their rate", residential customers are discriminated against since they cannot obtain service under such an arrangement. Public Counsel also observes that a customer can obtain service functionally equivalent to Centrex

service through the use of a PBX with certain feature packages, but that Two-Tier contracts are not available for Centrex service while they are available for PBX service. Public Counsel further avers that equipment provided under Two-Tier contracts stays in rate base as the authorized rate of return on rate base changes from rate case to rate case. However, the revenues associated with such equipment will not vary, due to the fixed nature of Tier A charges. The shortfall in return generated by this mismatch will be paid by residually priced basic services, in Public Counsel's view.

However, the Commission retains jurisdiction over Tier A rates and may order such rates increased if it deems such action necessary to ensure that Two-Tier customers will pay the full capital cost associated with their service. Such authority is recognized in the terms of Missouri Two-Tier contracts. Thus, the Commission has the ability to prevent the "shortfall in return" feared by Public Counsel. There is no evidence in this case showing that such a shortfall in return, due to fixed Tier A rates, is occurring. On the other hand, the Company observes that Two-Tier customers assure full capital recovery by signing contracts which guarantee full capital recovery even if there is a premature disconnection of service. Non-Two-Tier customers (including residential customers) do not obligate themselves to pay the full capital costs of their services and can disconnect service at any time without future obligation.

The Company also denies that Two-Tier pricing has been utilized to accomplish "migration strategy". Actually, none of the services which Public Counsel's witness identified as being the object of migration strategy is proposed to be increased in this case.

The Staff opposes Public Counsel's proposal, and considers it appropriate to leave Tier A charges for existing customers at levels related to capital costs when they became customers. The Staff also rejects Public Counsel's argument that leaving Tier A charges fixed is discriminatory. The State of Missouri supports the Staff's position on this issue.

In its Order in Case No. 18,565 (November 20, 1978), the Commission found that the Two-Tier rate plan is not discriminatory, but is in the public interest since it gives the telephone company assurance that its capital costs will be paid by the customer using the service. The Commission found that this is a benefit to other customers. The Commission finds and concludes that Public Counsel has not shown in this case that the Two-Tier pricing option is discriminatory.

Public Counsel's proposal is rejected.

18. Category Cost of Service Study

The Public Counsel advocates the use of a category cost of service study (CCS) for the evaluation of past pricing decisions of the Company. It is Public Counsel's position that a CCS study utilizing "proper separations procedures" will assist the Commission in determining what return Company's services are earning and which services require rate adjustments.

The Company opposes the use of a CCS study in evaluating past pricing decisions. Company currently performs an Embedded Direct Analysis (EDA) study to track past pricing decisions. The Company's position is that the EDA, which is a directly assigned cost study, is superior to the CCS, which is a fully allocated cost study, in tracking the results of past pricing decisions. It is further the Company's position that neither study is useful for proposing prospective rates for individual products and services.

The Staff does not support Public Counsel's proposal on this issue, contending that implementation of this procedure would require allocating portions of capital investment to certain services and that this cannot be undertaken with any appropriate degree of accuracy.

As stated earlier, Public Counsel urges the Commission to reconsider the approach established in P.S.C. Case No. 18,309, alleging that the underlying assumption of the Commission's decision in that case was that incremental unit costs would always be higher than actual or embedded costs, and that this assumption has

proven erroneous. Public Counsel asserts that the Company's Embedded Direct Analysis shows certain broad categories of competitive and nonbasic services which do not even recover their own actual direct costs [for example, interexchange private line service, discussed hereinabove at Section XIV.B.10(c)]. Public Counsel asserts that the Company EDA shows that state private line and vertical business services do not recover their own direct costs, but that basic exchange services recover their costs and contribute to joint and common costs. The latter allegation assumes, however, that access line costs are allocated between local exchange and toll services, rather than being assigned to exchange services only.

Public Counsel proposes the use of a category cost of service study for rate design purposes in this case, using the Company EDA as a starting point, in lieu of reliance upon Company LRIA. Public Counsel asserts that the costing procedures established by the Commission in Case No. 18,309 permit the Company to manipulate costs and promote its marketing goals (and those of AT&T) at the expense of the Company's monopoly ratepayers. It is Public Counsel's position that the LRIA and IUC methodologies provide no regulatory accountability or any assurance that the costs which they calculate will bear any reasonable relationship to actual costs. As alleged by the Missouri Alarm Association in relation to private line rates, the Public Counsel asserts that the use of LRIA and IUC methodologies leaves the Company free to exploit its monopoly markets and subsidize what will be AT&T's competitive products and services. Public Counsel also recommends that the Company be ordered to perform embedded cost studies on all items of terminal equipment. The Company asserts that such a recommendation is largely moot, since it is unlikely that the Company will be filing a significant number of terminal equipment cost studies in future rate cases due to the impact of the FCC's Computer Inquiry II decision and the Modified Final Judgment.

As indicated previously, the record of this case causes the Commission to entertain serious questions as to the continued efficacy of the costing and rate

design framework established by Case No. 18,309. Obviously, if Category One or Category Three services do not in fact recover their own direct cost and appropriate share of joint and common costs, then basic exchange services would be priced above their cost so as to subsidize Category One and Category Three services. Public Counsel is correct in his assertion that such a result would not be consistent with the policies established by the Commission in Case No. 18,309. The record of this case also demonstrates that it may be possible to perform IUC studies so as to support the underpricing or overpricing of various services. [See Sections XIV.B.10(c) and (d)]. Where IUC studies are relied upon by the Company for its proposed pricing of a particular service, and the Commission thereupon determines that the IUC study in question is defective, the Commission is left with no option other than equal percentage increase pricing of that service, as in the case of private line services discussed hereinabove. However, the Commission cannot categorically conclude upon the record of this case that LRIA have no place in the pricing of telecommunications services, or that Public Counsel's proposed category cost of service study should be relied upon.

The Commission determines that it should be presented with additional costing options in this Company's next general rate case. The Commission will order the Company to submit a fully allocated cost study, based upon embedded costs, for all categories of service in addition to the presentation of IUC or LRIA studies with respect to services where IUC or LRIA studies are appropriate methodologies. The Commission is mindful, however, that significant changes will occur in the types of equipment which will be included in Southwestern Bell rates after the Modified Final Judgment is implemented on or before February 24, 1984. Therefore, embedded cost studies will not be required as to equipment which will not be included in Southwestern Bell rates after divestiture of Southwestern Bell by AT&T.

In addition, the parties are strongly encouraged to present to the Commission in SWB's next rate case, any other alternative costing methodologies which

they believe should be used by the Commission in setting rates. The continued validity of the three categories of service established by Case No. 18,309 and their intended contribution to the total revenue requirement of the Company should also be the subject of complete review in the next rate case.

The Commission cannot, and will not, determine in this case the method of costing and framework for allocation of costs which will be applied in Southwestern Bell's next general rate case. While inviting review of Case No. 18,309, the Commission is not prepared to announce the ultimate demise of that decision. The Commission is, however, persuaded by the record of this case that the underlying assumptions of Case No. 18,309 and the pricing methodologies and allocation framework established thereby are in need of continuing and careful review, and that the Commission needs to assure that it will be presented with alternative methodologies in future rate cases.

#### 19. Customer Billing

Public Counsel proposes that the Company be required to disaggregate its charges to customers on their monthly bills in order to show monthly customer premises equipment (CPE) charges separately from other monthly charges. This recommendation of the Public Counsel is made in conjunction with the Public Counsel's proposal concerning the sale of installed base equipment to customers, discussed hereinabove at Section XIV.B.16. The Company believes that Public Counsel's billing proposal raises questions which are outside the scope of this case. The Company asserts that all telephone companies are required to comply with the Commission's uniform service and billing practices, codified at 4 CSR 240-33. It is the Company's position that if the Public Counsel wishes to institute changes in such procedures, such changes should be proposed in a rulemaking proceeding involving all telephone companies.

The Commission Staff asserts that these billing procedures are covered by a Commission rule which requires disaggregation on a customer's first bill for new

service. Staff agrees with the Company that Public Counsel's proposal would be an appropriate subject for a rulemaking proceeding applicable to all telephone companies, rather than in the instant rate case.

Existing Commission rule 4 CSR 240-33.040(8) provides as follows:

During the first billing period in which a customer receives service, a customer must receive an insert or other written notice which contains an itemized account of the charges for the equipment and service for which he has contracted.

Under 4 CSR 240-33.040(6), requirements are set out for every bill sent by a telephone utility to a customer of that utility. Those requirements include a statement of the amount due for basic service, an itemization of the amount due for toll service, and an itemization of the amount due for taxes and franchise fees. Telephone utilities are not required, by a Commission rule, to disaggregate CPE charges on each monthly bill.

The Commission finds that the Public Counsel's proposal in this respect is a proper subject of the separate docket being established below to investigate the possibility of sale of installed base equipment by Southwestern Bell. [See Section XIV.B.16, above].

C. Rate Design Summary

Based upon the competent and substantial evidence upon the whole record of this case, and upon its decisions concerning the contested rate design issues set out hereinabove, the Commission determines that the appropriate rate design to be applied to the revenue requirement deficiency found by the Commission in this case is as follows:

General Exchange/Vertical Services/IUC Studies	\$ 9,565,700
Restructured CTX-C.U./Package PBX	(75,700)
Restructured Local Exchange	1,611,100
Eliminating Four-party OBRA Mileage	(486,200)
Private Line Nonrecurring (50 percent of cost)	4,918,000
WATS	(1,642,400)
Eliminating Direct/J.U. Schedules	138,700
Local Conference	(200)
Restructured CTX-C.O. -- (25 percent contribution)	6,340,700
Directory Assistance	3,755,700
Direct Inward Dialing	1,230,000
OCC	3,000
Hotel/Motel Station Lines	<u>13,600</u>
 TOTAL SPECIFIC RATE ADJUSTMENTS	 \$25,372,000
 TOTAL REVENUE DEFICIENCY (See Section XIII Above)	 <u>\$63,771,000</u>
 REMAINDER	 \$38,399,000

The remainder of the revenue requirement as determined herein shall be recovered as a uniform percentage increase applied to all categories of local exchange service, recurring rates for private line service, toll (including the first four rate steps), WATS access line and usage rates, and direct inward dialing.

XV. Public Counsel Motion For Separate Docket

On September 13, 1982, the Office of the Public Counsel filed its Motion in this case requesting the creation of a separate docket concerning the impact and implementation of the Modified Final Judgment (MFJ) in the antitrust lawsuit by the Department of Justice against AT&T, and of the FCC's Decision in Computer Inquiry II, upon Southwestern Bell, its ratepayers, its stockholders and the telecommunications industry in Missouri. Public Counsel suggests that this proceeding be designated as an ongoing one in which hearings could be held periodically to consider the innumerable issues of fact and public policy which have developed, and are expected to develop, as the Bell System and the telecommunications industry are restructured.

On November 20, 1974, the United States Department of Justice (DOJ) filed an antitrust action against American Telephone & Telegraph Company (AT&T), Western Electric Company, Inc. (Western Electric), and Bell Telephone Laboratories, Inc. (Bell Labs) in the United States District Court for the District of Columbia.

United States v. AT&T, et al., Civil Action No. 74-1698 (D.C. Dist.). This case will be referred to as the "DOJ lawsuit". The parties to the DOJ lawsuit arrived at a settlement of that case in January 1982, which involved dismissal of the DOJ lawsuit and a modification of the Consent Decree entered in a different lawsuit (in the United States District Court for the District of New Jersey) in 1956. The stipulated judgment in that case (United States v. Western Electric Company, Inc. and AT&T, Civil Action No. 82-0192) is referred to as the "1956 Consent Decree".

The Honorable Harold H. Greene, United States Circuit Judge for the District of Columbia, proposed modifications to the proposed settlement of the parties, based on public comments, additional hearings and briefs on matters of interest to the Court. The modifications proposed by the judge were adopted by the parties. On August 24, 1982, Judge Greene issued his Order approving the Stipulation of Dismissal of the DOJ lawsuit, and ordering the case dismissed; and approving the modification of the 1956 Consent Decree. Judge Greene's Order is referred to as the Modified Final Judgment (MFJ).

As a result of the MFJ, AT&T will divest itself of Southwestern Bell Telephone Company and the other Bell Operating Companies (BOCs), and SWB and the other BOCs will no longer be affiliated with Western Electric or Bell Labs. Southwestern Bell will also be prohibited from engaging in interexchange telecommunications services and will be divested of its customer premises and interexchange toll equipment. These changes are required by the MFJ to occur on or before February 24, 1984. There are indications that the changes may in fact be implemented on or about January 1, 1984.

Other significant changes in the structure and operation of telecommunications firms will result, effective January 1, 1983, as a result of the FCC's Decision in its Second Computer Inquiry ("Computer Inquiry II"), FCC Docket 20828, Final Decision, 77 F.C.C.2d 384 (1980); Reconsideration Order, 84 F.C.C.2d 50 (1980); Further Reconsideration Order, 88 F.C.C.2d 512 (1981). As a

result of Computer Inquiry II, neither AT&T nor its operating companies will market new customer premises equipment. Rather, such equipment will be marketed by a new fully-separated subsidiary of AT&T, to be known as American Bell, Inc. (ABI). Since Southwestern Bell will no longer offer new customer premises equipment after January 1, 1983, SWB must enter into a contract with American Bell for Southwestern Bell to install and maintain new CPE business services for ABI. In addition, Southwestern Bell will be transferring to ABI certain personnel, equipment and leases presently used by SWB in the provision of utility services and related activities.

Public Counsel believes that it is urgent that the Commission exercise an oversight function throughout the planning and implementation of Computer Inquiry II and of MFJ, paying particular attention to transfers of appropriate personnel from SWB to AT&T-owned entities, intercompany leasing arrangements with regard to jointly-used plant or services, and valuation and transfer of assets. Public Counsel urges the development of a functional accounting system to effectively account for intercompany relations between exchange and interexchange telephone companies, and to require periodic reports and hearings to keep the Commission and other interested parties advised of developments and to allow their participation in the planning and implementation processes.

The Commission determines that the Public Counsel's Motion for a separate docket should be granted. The separate docket to be created will be known as "In the matter of the investigation into the implementation by Southwestern Bell Telephone Company of Computer Inquiry II and the Modified Final Judgment." It is the Commission's intention that the docket be broad in scope and comprehensive in nature. The Commission will, by separate order issued in the new docket, direct Southwestern Bell to file regular reports, at least monthly, advising the Commission of the status of the Company's implementation of Computer Inquiry II and of MFJ. The Commission may also order hearings or generate separate, more specific dockets at any time it is deemed necessary upon the Commission's own motion or upon motions filed by other

parties to the proceeding. If any aspect of implementation seems to require more concentrated attention than seems reasonable within the framework of the broad separate docket, an additional docket may be instituted, such as the Commission has already done in TO-83-57 with respect to revenue requirement impact of Computer Inquiry II. The main separate docket should provide an effective vehicle for the Commission for monitoring of the Company's steps in implementing Computer Inquiry II and MFJ by the Commission and by other interested parties, and provide a procedural base for necessary inquiry or action concerning the restructuring of the Company.

XVI. Treatment of Rate Effects of Computer Inquiry II

On August 6, 1982, Southwestern Bell filed with the Commission tariff sheets designed to deregulate customer premises equipment (CPE) after December 31, 1982, in order to comply with the FCC's Decision in Computer Inquiry II. By Order issued September 3, 1982, the Commission suspended the proposed effective date of those tariff sheets from September 6, 1982, until January 4, 1983, and assigned those tariff sheets to Case No. TO-83-57. That Order also established a prehearing conference in the case, which was held on September 13, 1982.

Since the Computer Inquiry II Decision of the FCC will be implemented on January 1, 1983, the resulting transfer of employees, assets and PhoneCenter leases will undoubtedly have an impact on the Company's revenue requirement. While the Staff identified an early Company estimate of that revenue requirement impact, no party to this case proposed any adjustment based upon the January 1, 1983, implementation of Computer Inquiry II. The parties generally agreed instead that the instant case should be tried on a "business as usual" basis, based entirely upon revenues, expenses and investment during a true-up historical test year. The apparent consensus of the parties was that the revenue requirement effects of Computer Inquiry II implementation could not be identified with absolute certainty until after such implementation had occurred, and that any attempt to account for such revenue requirement effects in this case would violate the integrity of the

historic test year. No serious effort was made by any party to this proceeding to project the revenue requirement impact of Computer Inquiry II implementation upon the rates to be established in this case.

By Order issued October 1, 1982, in this case, the Commission directed counsel to orally address the impact of the implementation of Computer Inquiry II upon the rates to be set in this case, on Thursday, October 7, 1982. Such oral statements were taken by the Commission on that date. By Order issued October 20, 1982, in the instant case and in Case No. TO-83-57, the Commission directed the parties to Case No. TO-83-57 to prepare and submit to the Commission a definitive document defining the issues to be addressed in Case No. TO-83-57 and committing the parties to a course of action "clearly defined to appropriately resolve those issues." The parties were directed to address the question of whether the revenue requirement effect of Computer Inquiry II implementation would be addressed in Case No. TO-83-57 and, if so, in what manner; suggest a proposed audit, prehearing conference and hearing schedule including (if possible) agreement as to the test period of actual experience after Computer Inquiry II implementation to be utilized; and set forth any agreements among the parties as to the relation back to January 1, 1983 (or some other date) of any rates to be set or adjusted in TO-83-57. By that Order, the Commission deferred any determination as to what treatment should be given in Case No. TR-82-199 to the direct revenue requirement effects of Computer Inquiry II implementation as of January 1, 1983.

On November 5, 1982, the parties to Case No. TO-83-57 (Company, Staff and Public Counsel) filed a "Memorandum of Agreement" in that case, pursuant to the Commission's directive in its Order of October 20, 1982. That Memorandum of Agreement addresses subjects relating to the appropriate tariffs necessary to accomplish deregulation and concerning the transfer of certain SWB assets to American Bell, Inc., which are not related to the issue of the Company's revenue requirement to be determined in the instant case. In the Memorandum of Agreement filed

November 5, 1982, the parties to Case No. TO-83-57 also agreed that the implementation of Computer Inquiry II would have an effect upon Company's Missouri jurisdictional revenue requirement, but also agreed that such an effect was not then capable of precise quantification. The Company and Staff agreed that a "true-up" proceeding should be held during 1983 in which the actual revenues, expenses and plant of the Company would be audited through March 31, 1983, and hearings conducted in late May or early June, 1983. Company and Staff agreed that any revenue requirement increase which would be authorized under this procedure in Case No. TO-83-57 would be recovered on a prospective basis only, from the effective date of the order in that case; but that any revenue requirement reduction which might be authorized by the Commission in that case should relate back to January 1, 1983. Company and Staff further agreed that any revenue requirement increase or decrease in Case No. TO-83-57 should be accomplished (to the extent possible) by a uniform percentage rate change to all Company recurring rates. This procedure, it was suggested by Staff and the Company, would permit an accounting of the revenue requirement impact of Computer Inquiry II implementation while also maintaining an accurate match of revenues, expenses and plant of the Company.

On the other hand, the Memorandum of Agreement of November 5, 1982, also sets out Public Counsel's untimely position that the preferable method for meeting the Commission's concern about the possible revenue requirement effects of Computer Inquiry II implementation was for the Commission to convene additional hearings in November 1982 to take additional evidence and arguments of the parties concerning this issue. Public Counsel believes that there is no statutory authority for the "true-up" procedure proposed by the Company and the Staff.

On November 17, 1982, the Commission issued another joint order in Case Nos. TR-82-199 and TO-83-57, announcing that no additional hearings would be held in Case No. TR-82-199 concerning the revenue requirement impact of Computer Inquiry II implementation.

The Commission has determined that the recommendation of the Company and the Staff in the Memorandum of Agreement in Case No. TO-83-57 should be approved, and will do so by separate order. The Commission is persuaded that the approach recommended by the Company and Staff is the most efficient and effective way of considering the revenue requirement impact of Computer Inquiry II implementation by Southwestern Bell. The Commission notes, as it did in its Order of November 17, 1982, that other methods of accounting for those rate effects are available, such as the filing of a formal complaint by the Staff or Public Counsel pursuant to Section 386.390, R.S.Mo. 1978, and/or the filing of new proposed rate tariffs by the Company.

The Commission also feels compelled to express its disappointment that no serious effort was made by any party to this case to develop a method which would have accounted for the effects of Computer Inquiry II implementation while still maintaining the vital matching of revenues, expenses and plant within the test year. As discussed below under Section XVII, "Test Years in Future Rate Cases", the Commission is not in a position at this time to state that it would prefer the use of a different approach in general rate cases. However, given the unique circumstances of Computer Inquiry II implementation vis-a-vis the operation of law date of the rate tariffs filed in Case No. TR-82-199, the Commission is frankly disappointed that no party saw fit to attempt to account for the impacts of Computer Inquiry II which will begin even before this Order is effective. The Commission will direct the parties, in Southwestern Bell's next rate case, to carefully examine the possible use of alternative methodologies.

For purposes of the instant case, however, the Commission cannot find competent and substantial evidence upon which to base an adjustment in rates to account for the implementation of Computer Inquiry II on or about January 1, 1983, while maintaining the essential matching of revenues, expenses and investment during the test period. Further, as will be addressed by a separate Order in Case

No. TO-83-57, the Commission is accepting the proposal of the Company and Staff in Case No. TO-83-57 for an additional audit and hearings in that case in order to adjust rates based on early-1983 operating experience.

XVII. Test Years in Future Rate Cases

As discussed in detail immediately above (Section XVI), the Commission is of the opinion that every effort should be made in the next general rate case involving Southwestern Bell to develop and present alternative methodologies, including the use of an approach such as that utilized in TO-83-57, or forward-looking data, while maintaining a careful matching of revenues, expenses and plant, upon which to set rates. While the Commission is not committing itself in advance to adopt a different approach, the unique circumstances surrounding the implementation of the MFJ on or before February 24, 1984, and the effects of divestiture upon Southwestern Bell's revenue requirement, are of serious concern to the Commission. Obviously, a "business as usual" approach to the next Southwestern Bell rate case would be wholly unacceptable, since divestiture will cause a radical restructuring of Southwestern Bell. Thus, it is imperative that great energy and concentration be devoted to attempts to develop alternative methodologies for use in the next rate case.

Other issues in the instant case compel a similar concern. For example, the Company's proposal to include short-term telephone plant under construction (TPUC) in its rate base presents the Commission with a "matching" problem -- i.e., can short-term TPUC be included in rate base without matching revenues and expenses related to such plant? The integrity of the historic test year has also been an issue in this case in relation to some of the separations issues (see Section VIII, above). The Commission believes it should maintain a proper matching of revenues, expenses and plant with whatever methodology is utilized. In the instant case, the Commission has been careful to attempt to maintain the integrity of the historic

test year agreed upon by the parties, because no other options were presented to the Commission.

Therefore, Southwestern Bell and the Staff are directed, and Public Counsel and other parties are invited, to develop an approach using other methodologies, including but not limited to an approach such as that utilized in TO-83-57, or forward-looking data, in this company's next general rate case, provided they maintain a proper matching of revenues, expenses and plant within the methodology utilized.

#### Conclusions

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

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

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

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

When a public utility's existing rates and charges for telephone service are found to be insufficient to yield reasonable compensation for the service

rendered, the Commission shall authorize revisions to the Company's applicable tariffs which will yield an appropriate fair return on the Company's property. The resulting rates shall be fair, just, reasonable and sufficient, and shall not be unduly discriminatory or unduly preferential. When tariffs filed by a public utility are designed to produce revenues in excess of those found to be just and reasonable, said tariffs should not be allowed to become effective as requested.

Based upon the Commission's findings herein, the tariffs filed by SWB in Case No. TR-82-199 should be disallowed, and the Company should be authorized to file revised tariffs in conformance with the findings of this Report and Order.

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

It is, therefore,

ORDERED: 1. That the revised tariffs filed by Southwestern Bell Telephone Company in Case No. TR-82-199 be, and the same are, hereby disapproved, and the Company is authorized to file in lieu thereof, for approval by this Commission, revised tariffs designed to increase gross annual revenues by \$63,771,000, exclusive of gross receipts and franchise taxes; and that said revised tariffs shall be in conformance with the rate design and other findings contained in this Report and Order.

ORDERED: 2. That Southwestern Bell Telephone Company be, and is hereby, ordered and directed to keep accurate and detailed records segregating all of its expenses associated with Missouri intrastate rate case proceedings, including the specific items listed in Public Counsel's proposal in this case at Section IV.J of this Report and Order.

ORDERED: 3. That P.S.C. Case No. 00-83-220 be, and is hereby, established as a generic proceeding on the subject of normalization versus flow-through treatment

of tax timing differences. The case shall be styled, "In the matter of the inquiry into whether tax timing differences should be normalized".

ORDERED: 4. That Southwestern Bell Telephone Company be, and is hereby, ordered and directed to submit a progress report to the Communications Department Staff of the Commission every thirty (30) days on the status of all major faults in cable pairs located in outside plant facilities, located by the Staff, which the Company had not eliminated by the end of the hearing in this case. Further, such reports shall continue to be regularly filed until the Company has eliminated all of the major faults which the Staff located.

ORDERED: 5. That P.S.C. Case No. TO-83-221 be, and is hereby, established for the purpose of investigating Southwestern Bell Telephone Company's plans for the sale of installed base equipment to customers; and that Southwestern Bell be, and is hereby, ordered and directed to file in said Case No. TO-83-221, within ten (10) days of the effective date of this Report and Order, a report concerning its plans to sell installed base equipment to its customers. Said report shall also address the proposal of the Public Counsel in this case that charges to Southwestern Bell customers on their monthly bills be disaggregated to show the monthly customer premises equipment charges separately from other monthly charges. Said docket shall be styled, "In the matter of the sale of embedded base equipment to customers of Southwestern Bell Telephone Company".

ORDERED: 6. That Southwestern Bell Telephone Company be, and is hereby, ordered and directed to submit a fully allocated cost study based upon embedded costs in its next general rate case for all services, in addition to the presentation of incremental cost studies or long run incremental analyses with respect to services where those are appropriate methodologies, except as to equipment which will not be included in Southwestern Bell rates after divestiture of Southwestern Bell by AT&T.

ORDERED: 7. That the parties to this proceeding are strongly encouraged to present to the Commission in Southwestern Bell's next rate case alternative


costing methodologies which they believe should be used by this Commission in setting rates, and to address the continued efficacy of the costing methodologies and pricing framework approved and established in P.S.C. Case No. 18,309.

ORDERED: 8. That P.S.C. Case No. TO-83-222 be, and is hereby, established for the purpose of monitoring, and taking necessary action in relation to, Southwestern Bell's implementation of Computer Inquiry II and of the Modified Final Judgment. Said case shall be styled, "In the matter of the investigation into the implementation by Southwestern Bell Telephone Company of Computer Inquiry II and the Modified Final Judgment".

ORDERED: 9. That the rates to be established through revised tariffs conforming to the Commission's findings and conclusions in this Report and Order may become effective for service rendered on and after the effective date of this Report and Order.

ORDERED: 10. That this Report and Order shall become effective on the 14th day of January, 1983.

BY THE COMMISSION



Harvey G. Hubbs  
Secretary

(S E A L)

Fraas, Chm., Dority, Shapleigh  
and Misgrave, CC., Concur and  
certify compliance with the  
provisions of Section 536.080,  
R.S.Mo. 1978.  
McCartney, C., Not Participating.

Dated at Jefferson City, Missouri,  
on this 30th day of December, 1982.