COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

NOTICE OF CONTINENTAL TELEPHONE COMPANY OF KENTUCKY OF AN ADJUSTMENT IN ITS RATES	)))	CASE NO. 9230

O R D E R

On December 28, 1984, Continental Telephone Company of Kentucky ("Continental") filed notice with the Commission proposing to increase its intrastate telephone rates for service rendered effective January 17, 1985. On June 20, 1985, the Commission issued its Order in this proceeding in which it approved rates and charges that would produce an increase in annual revenues of $219,184.

On July 10, 1985, Continental filed its petition for rehearing on the following issues: wages and wage-related expenses, the disallowance of the customer premises equipment adjustment ("CPE"), toll revenue and official toll, private line revenue, affiliated expenses and rate of return. On July 10, 1985, the Attorney General ("AG") filed its petition for rehearing stating that the Commission should reduce Continental's rates based on its contention that a revenue sufficiency exits. The AG submitted that the Commission should lower the allowed rate of return on equity and increase the revenues associated with intrastate toll, resulting in lower rates for Continental's customers. The Commission addresses these issues raised by Continental and the AG as follows:

Wage and Wage-Related Expenses

Continental, in its original filing, requested annual wage adjustments for its employees of 6 percent effective in December 1984 for management employees and February 1985 for craft employees. Subsequent to the original filing the increase for the craft employees was reduced to a 5 percent increase. The Commission granted the full increase to the craft employees and reduced the increase to the management employees to the same 5 percent granted craft employees for rate-making purposes. Continental in its petition maintained that the increases to management employees were justifiable and should not be limited to the level awarded the craft employees.

Continental presented no new evidence or arguments not considered in the Commission's Order in justifying its position on this issue and the Commission is of the opinion that rehearing on this issue should be denied.

Loss In Terminal Equipment Revenue

Continental proposed in its initial application to reduce local service revenue by $513,743 to reflect the anticipated decline in leased terminal equipment resulting from the FCC's deregulation of new CPE effective January 1, 1983. In its Order of June 20, 1985, the Commission rejected Continental's adjustment using criteria similar to that used in rejecting a similar adjustment in Continental's last rate case, Case No. 9011.[1] In that proceeding Continental also requested rehearing on many of the same premises taken in its current petition for rehearing. As stated in its June 20, 1985, Order, Continental presented no new or additional evidence supporting its position, but merely extended its earlier presentation found in Case No. 9011 to the current rate case.

Continental's petition for rehearing in this case actually gives additional credence that the linear projection used by Continental in this adjustment is not an appropriate method to determine the decline of revenue from leased terminal equipment. Continental predicted a decline of $513,743, the actual decline since the end of the test period was $177,648 on an annual basis, significantly lower than the prediction. Thus the Commission maintains its finding that Continental's methodology is inappropriate and should be denied.

Anticipating denial, Continental stated that at the very least, the Commission must recognize the annualized decrease in terminal equipment revenue which occurred since the end of the test period. The Commission finds no merit to this request since productivity changes subsequent to the end of the test period are never considered, and an isolated adjustment for this single change would distort the projected earnings level and result in a mismatch of earnings and capital. Thus, the Commission finds the

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1 Notice of Continental Telephone Company of Kentucky of an Ajustment in its Rates, dated October 5, 1984.

arguments made by Continental on this issue to be unpersuasive and therefore will not allow rehearing on this issue.

Toll and Official Toll

The Commission in its June 20, 1985, Order used Continental's actual toll revenue recorded during the test period in this case. Continental in its petition maintains that the test period level used by the Commission, which included 2 months of 1983, was not appropriate because of changes resulting from divestiture and prior year true-ups. The AG similarly petitioned that a more appropriate level of toll revenue would be based on the 12-month period subsequent to divestiture. In an effort to determine the appropriate ongoing level of toll revenue, the Commission will rehear this issue. Continental should file testimony and exhibits showing in detail transactions in the toll revenue accounts during the test period and the months subsequent to the test period. Subtotals should be provided for the test period, the 12 months ended December 31, 1984, and the latest 12 months. All out of period adjustments (both prior and future) should be noted in full detail.

To afford Continental further opportunity to refute the Commission's determination of official toll, rehearing on this issue will be granted. Continental should file testimony and exhibits showing both the prior and current treatment of official toll. This analysis should be shown separately for interstate, intrastate intraLATA and intrastate interLATA official toll. Again, data should be provided for the test period, the 12 months ended December 31, 1984, and the latest 12 months.

Private Line Revenue

Continental contends in its petition for rehearing that changes in the private line billing rates would not affect the settlements level received. Therefore, upon presentation of testimony, the Commission will rehear this issue.

Affiliated Expenses

Continental contends in its petition that the Commission adjustment to affiliated expenses is unreasonable for two reasons; first it compares incomparable items and second it adjusts items already adjusted. Continental stated that the Commission's adjustment assumes that the affiliated services provided in the base year are the same as those provided in the test period and went on to show that the test period included at least three services not provided in the base year. The Commission recognizes that services change from year to year and will allow rehearing on this issue.

However, the Commission requires that Continental file testimony and exhibits identifying affiliated services expensed during the period of 1978 through the test period with full disclosure of all additions or deletions of services from year to year. Continental should also provide the amounts and subaccount(s) to which each of these services was charged and for the test year should identify any and all adjustments accepted or made by the Commission in its Order of June 20, 1985, which changed the amounts recorded in these subaccounts for rate-making purposes.

Rate of Return

Both Continental and the AG filed requests for rehearing on the issue of return on equity. Continental requested at least a 15 percent return on equity (the upper end of the Commission's reasonable range) because the Commission disallowed its attrition adjustment, thus impairing Continental's ability to earn a return on equity within the reasonable range.[2] All forseeable risks are factored into the investor required return. The return on equity granted by the Commission is an approximation of the investor required return. No utility is guaranteed to earn its allowed return on equity. That is one of the risks for which the utility is compensated. Continental did not present any new evidence in its application for rehearing. Therefore, the Commission is of the opinion that Continental's request for rehearing on the issue of return on equity should be denied.

The AG recommended lowering Continental's allowed return on equity to 14 percent.[3] On page 3 of its Petition for Rehearing, the AG stated the following:

> The facts of record as indicated at page 23 and 24 of the order generate a DCF of between 12-14%. It is clear that the PSC order found a proper growth component to be in the 5-6% range. The yield component as found by the PSC is in the 7-8% range.

In its Order, the Commission pointed out alternative estimates of the appropriate dividend growth rate (such as Value

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2 Continental Petition for Rehearing, page 20.

3 AG's Petition for Rehearing, page 3.

Line's estimate). The Commission also pointed out that stock prices were rising, thus lowering spot dividend yields. The Commission did not indicate a proper growth component nor a proper dividend yield. The AG did not present any new evidence in its application for rehearing. Therefore, the Commission is of the opinion that the AG's request for rehearing on the issue of return on equity should be denied.

SUMMARY

The Commission, being advised, is of the opinion and finds that:

1. Continental's petition for rehearing should be granted in part and denied in part, specifically the issues of toll revenue, official toll revenue, private line revenue and affiliated transaction should be granted and the issues of wages and wage-related expenses, loss in terminal equipment revenue and return on equity should be denied.

2. The AG's petition for rehearing should be granted in part and denied in part, specifically the issue of toll revenue should be granted and the issue of cost of equity should be denied.

IT IS THEREFORE ORDERED that concurrent with the discussion and findings herein, Continental's and the AG's petitions for rehearing shall be granted in part and denied in part.

IT IS THEREFORE ORDERED that testimony and exhibits as required in the text of this Order shall be filed within 30 days of the date of this Order.

Done at Frankfort, Kentucky, this 26th day of July, 1985.

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.

Chairman

Vice Chairman

not participating

Commissioner

ATTEST:

Secretary