COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF RATES OF THE LEWISPORT) CASE NO.
TELEPHONE COMPANY) 93-133

O R D E R

On June 16, 1993, Lewisport Telephone Company, Inc. ("Lewisport") filed its application proposing adjustments in its rates and charges pursuant to KRS 278.180. On June 29, 1993, the Commission, pursuant to KRS 278.190 suspended the proposed tariff up to and including December 16, 1993. On October 28, 1993, due to Lewisport's requested continuance of the public hearing, the suspension was extended until January 28, 1994. On December 1, 1993, the suspension was extended until March 1, 1994, so that Lewisport would have sufficient time to provide information requested at the public hearing and prepare its brief.

Lewisport's filing requested an increase in revenues of $92,723. The requested increase would result in an average increase to residential customers of 64.7 percent. Based upon the findings and determinations herein, the Commission has approved rates and charges to produce an annual increase of $65,502, which results in an increase to residential customers of 44.1 percent.

Although no parties requested intervention in this proceeding, two customers filed protest letters. On December 1, 1993, a public hearing was held at the Commission's offices in Frankfort, Kentucky. Lewisport's brief was filed on January 18, 1994, and responses have been submitted to all requests for information.

This Order addresses the Commission's findings and determinations with regard to its investigation of Lewisport's revenue requirements and rate design.

TEST PERIOD

Lewisport proposed and the Commission accepted the 12-month period ending December 31, 1992 as the test period in this proceeding.

NET INVESTMENT RATE BASE

Lewisport proposed a net investment rate base of $2,386,091 based upon actual test-year-end account balances updated to reflect construction projects completed and placed in service through May 31, 1993.[1]

Lewisport's proposal to update its rate base to reflect additions through May 1993 represents a departure from the Commission's normal practice of basing net-investment on test-year-end account balances. Lewisport's justification for this departure is that its central office and outside plant were almost entirely replaced between December 1992 and May 1993, and, absent an adjustment to reflect these replacements, on-going rates would not reflect current investments.

Lewisport's proposed post-test-period additions to rate base should be accepted. The construction involved tremendous

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[1] Application, Section 10 (11)(6)(c), Handley, Prefiled Testimony, Exhibit G.

investment on the part of Lewisport and resulted in substantial improvements to the system. Disallowance of these additions would result in a rate structure which would not recognize reasonable and authorized investment currently in place, and would allow the ratepayers to enjoy the benefits of the investment without compensation to the utility. Adjustments reflecting identifiable savings to operating expenses and additional pro forma revenues associated with the construction have been made by Lewisport to maintain proper matching.

Lewisport included a $7,705 deduction to its rate base associated with customer deposits. However, customer deposits do not represent a cost-free source of funds, but rather bear interest as required by the Commission's regulations. Therefore, no deduction for customer deposits has been made.

Lewisport's proposed accumulated depreciation balance has been increased by $13,874 to correspond with the revised depreciation expense adjustment. Also, the post-retirement benefit deduction has been reduced by $4,302 to reflect the Commission's decisions relating to the corresponding expense as discussed in a later section of this Order.

The Commission has determined Lewisport's net investment rate base to be as follows:

Plant In Service	$2,482,750	
Accumulated Depreciation	44,916	
Net Plant		$2,437,834
Add:		
Materials & Supplies	14,263	
Subtotal		$2,452,097

Less:		
Deferred Taxes	52,220	
AFUDC Deduction	10,450	
Post-Retirement Benefits	5,203	
Net Investment Rate Base		$2,384,224

REVENUES AND EXPENSES

The Commission has generally accepted the proposals included in Lewisport's application with the following exceptions:

Corporate Allocations

Lewisport is a wholly owned subsidiary of TDS Telecom, which is a business segment of Telephone and Data Systems, Inc. ("TDS"). Lewisport is one of three telephone companies owned by TDS in the Commonwealth of Kentucky, along with Salem Telephone Company, Inc. ("Salem") and Leslie County Telephone Company, Inc. The three Kentucky companies are a component of the Southeast Region of TDS headquartered in Knoxville, Tennessee. Each telephone company owned by TDS operates as a stand-alone entity.

As a member of the TDS system, Lewisport receives direct charges and a pro-rata portion of the corporate overheads of its parent and other senior affiliates. Six affiliated companies directly charged or allocated a total of $365,249 to Lewisport during the test year.[2] After consideration of adjustments, below-the-line bookings, and capitalizations, the total amount of affiliated charges Lewisport proposed to include in its cost of service was $177,506.[3]

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2 Application, Section 10(11)(6)(T)(1).

3 September 24, 1993, Data Request, Item 56f.

Total operating expenses and taxes for Lewisport for the test period were $608,586.[4] The allocated and directly charged costs from affiliates to Lewisport comprise a significant portion of the cost of service of Kentucky ratepayers. In fact, 28 percent of Lewisport's proposed operating expenses before taxes consist of affiliated charges. To ensure that the rates charged by Lewisport are fair, just, and reasonable, the reasonableness of these affiliated costs must be determined.

These allocations were investigated during a recent rate case filed by Salem.[5] TDS prepared a Value of Service Study ("VOS Study") to justify its corporate expense allocations. However, the Commission allowed only $24,438 of a requested $197,000 in corporate expenses for rate-making purposes.[6] The remainder of the corporate expenses were disallowed because 1) the substantial increase (40 percent) in operating expenses occurred immediately upon TDS's acquisition of Salem, and 2) Salem could not show "current tangible benefits" attributable to the increases.[7]

Lewisport's expense structure before and after the TDS acquisition is quite different from Salem's. Whereas Salem experienced a 40 percent increase in expenses,[8] Lewisport

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[4] Handley, Prefiled Testimony, Exhibit C.

[5] Case 91-217, Adjustment of Rates of the Salem Telephone Company, Inc.

[6] Id., Order dated February 28, 1992, page 9.

[7] Id., pages 6-12.

[8] Id., page 8.

experienced a slight decrease of .6 percent.[9] In fact, 1992 test year expense levels remain below the pre-acquisition 1989 levels.[10] This reduction strongly supports allowance of the allocations in this instance.

Also unlike Salem, Lewisport has cited specific tangible benefits on a before-and-after-acquisition basis. For example, prior to the acquisition, Lewisport's cable and wire facilities consisted primarily of air-core cable, most of which experienced moisture problems. As a result, customers experienced noise problems such as static, cross-talk, and humming.[11] The extensive replacements to outside plant have eliminated these problems.

Furthermore, the replacement of the pre-acquisition step-by-step switch with a digital switch has produced several tangible benefits. Services such as call waiting, call forwarding, and personal ringing are now available.[12] Also, the new switch will allow Lewisport to provide digital touch-tone, E911, and customized business offerings.[13] The availability of these new services are current tangible benefits to the ratepayers and satisfies the standard for justifying these allocations established in the Salem case.

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[9] September 24, 1993, Data Request, Item 22.

[10] Transcript of Evidence, pages 84-85.

[11] Transcript of Evidence, page 21.

[12] Lewisport's Brief, page 9.

[13] Id.

Lewisport has generally justified the inclusion of its proposed corporate allocations expenses. However, in the Salem VOS Study, these allocations were subjected to an evaluation of an independent outside auditor, Kiesling and Associates ("Kiesling"). Kiesling determined that nine individual items were inappropriate allocations for rate-making purposes.[14] In view of Kiesling's determination, the Commission finds that Kiesling's recommendations with respect to the disallowance of corporate allocations should be adopted in this case. The applicable Kiesling disallowances for Lewisport were $10,145 in the test year.[15] Lewisport's expenses have been reduced accordingly.

Amortization of Early Retirements

Lewisport proposed an adjustment of $51,104 to reflect the amortization of undepreciated balances of assets retired in conjunction with its system upgrade.[16] On June 24, 1993, Lewisport sought the Commission's approval to record these retirements and amortize the associated undepreciated balances over five years. Action on this accounting request was deferred pending a decision in this case.

In consideration of the considerable improvements to the system associated with these retirements, recognition of this amortization in cost of service is appropriate. The proposed 5-year amortization period, however, is inappropriate as it would

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[14] Salem VOS Study, page 15.

[15] Lewisport's January 28, 1994 filing.

[16] Application, Adjustment H.

distort Lewisport's true cost of service. Proper matching dictates that the amortization period reflect the average remaining life of the retired plant, which is 10.6 years.[17] Therefore, Lewisport's proposed adjustment is approved and the amortization period extended to 10 years.

Moreover, the Commission has imputed additional accumulated depreciation of $16,620 to reflect timely acceptance of the 1990 average schedule depreciation rates.[18] Lewisport rejected the 1990 rates relying on language, included in the Commission letter issuing the rates, that early retirements could not be booked if those rates were accepted.[19] As Lewisport was already under this limitation due to its prior acceptance of the 1987 average schedule rates, the rejection of the 1990 rates was without good cause. Imputation of additional depreciation reserves of $16,620 results in an adjustment to the early retirement of $23,890,[20] a reduction of $27,214 to Lewisport's proposed expense.

Depreciation Expense

Lewisport proposed an adjustment to depreciation expense of $6,761 based upon new plant additions through May 1993 and 1990

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17 Hearing Data Request, Item 2.

18 Hearing Data Request, Item 3.

19 September 24, 1993, Data Request, page 102.

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Reserve Deficiency	$255,520
Imputed Depreciation	16,620
Imputed Deficiency	238,900
Amortization Period	÷ 10
	$ 23,890

depreciation rates.[21] On August 27, 1993, the Commission issued its 1993 Depreciation rates. These rates were formally adopted by Lewisport by letter of September 10, 1993. On December 1, 1993, Lewisport filed a revised depreciation exhibit reflecting these rates which produce a $20,635 adjustment which is accepted.

Statement of Financial Accounting Standards No. 106 ("SFAS 106")

Lewisport proposed an adjustment of $15,842,[22] revised to $16,012,[23] to reflect its other post-retirement employee benefits ("OPEB") liability and related expense on an accrual basis, as required by SFAS 106, Employers' Accounting for Post-Retirement Benefits Other Than Pensions. OPEB liabilities arise from current and past promises to pay employee retirement benefits other than pensions. The Commission ruled in Case No. 92-043[24] that the rate-making treatment of these costs would be considered in a utility specific rate case.

Lewisport argues that the accrual basis is appropriate because it will match the current cost of providing service with the revenues generated by that service. It bases this argument on the

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21 Application, Adjustment G.

22 Application, Schedule 10.(11)(6)(a), page 30 of 42.

23 September 24, 1993, Data Request, Item 25h.

24 Case No. 92-043, The Joint Petition Of Kentucky Power Company, Kentucky Utilities Company, Louisville Gas and Electric Company, And Union Light, Heat And Power Company For Certain Accounting And Rate-Making Authority Associated With The Implementation Of Statement Of Financial Accounting Standards No. 106.

premise that post-retirement benefits are part of an employee's compensation for services currently rendered.

The accrual basis for OPEB costs best reflects the true cost of providing service to current customers. Therefore, Lewisport's updated calculation of the SFAS 106 expense for the test year is accepted subject to the following limitation.

Medical Trend Rate - Lewisport proposed a medical trend rate starting at 15 percent and descending to 6.5 percent over ten years. This was based on studies performed by its actuarial consultant, Hewitt Associates. Lewisport argues that for the Commission to suggest a different rate would be arbitrary and wrong.[25] However, it also stated that there is "...considerable judgment in all those assumptions..." used in calculating OPEB expense.[26] Further, Lewisport argues that its medical trend rate is based on historical data and therefore reasonable.[27] However, this data was taken from TDS companies nationwide and was not specific to Lewisport or Kentucky.[28]

In a recent Kentucky-American rate case,[29] the Commission determined that a 15 percent medical trend rate was relatively high in comparison with other jurisdictional companies. Given the

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25 Transcript of Evidence, page 134.

26 Transcript of Evidence, page 131.

27 Transcript of Evidence, page 132.

28 Transcript of Evidence, pages 132-133.

29 Case No. 92-452, Adjustment of Rates of Kentucky-American Water Company.

admitted uncertainty of Lewisport's assumptions, the non-company-specific study relied upon, and Lewisport's failure to meet its burden of justifying its company-specific proposed rate, the Commission has reduced the medical trend rate by three percentage points for the test period, based on its findings in the Kentucky-American case.

This adjustment reduces Lewisport's revised proposed OPEB expense from $16,012 to $8,672,[30] a decrease of $7,340.

OPEB Expense Funding - Lewisport seeks to fund only the tax-deductible portion of OPEB expense, which it estimates to be 40 percent, and reduce rate base by the unfunded 60 percent. The company argues that it should not be required to fund OPEB expense 100 percent as it would be making a cash disbursement that would not be tax-deductible.[31] While this may be true, many other factors must be considered in deciding the funding issue. Among these are the expected decrease of OPEB expense in the long run with 100 percent funding, and whether this reduction would be more cost effective for the ratepayer than an offset to rate base.

Funding the tax-deductible amount of OPEB expense (40 percent) while reducing rate base by the resultant amount (60 percent) is reasonable in this case. In future cases the company should be prepared to show why funding less than 100 percent of OPEB costs is in the best interest of the ratepayers. Funding is required to the extent that it is cost effective. Further, as Lewisport's proposed

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30 September 24, 1993, data request, Item 25h.

31 Transcript of Evidence, page 174.

method will result in book-tax timing differences, any deferred tax balances resulting from the funding treatment will be closely scrutinized in any future rate case.

Nonregulated Allocation

Lewisport relies on TDS' Part-X Manual to exclude nonregulated expenses from regulated expense accounts. In its original application, Lewisport proposed to decrease regulated expenses by $10,833[32] to reflect proper implementation of the Part-X Manual and subsequently identified an additional $7,522[33] that should be excluded from regulated expenses.

The Commission has made an adjustment to reduce regulated expenses by an additional $7,522 for a total nonregulated adjustment of $18,355.

Manager Vehicle

As part of an overall compensation package, Lewisport's manager is provided a company vehicle. Under Lewisport's policies, the vehicle may be used for both business and personal uses. Expenditures that do not provide a demonstrable benefit to the ratepayers should not be borne by the ratepayers, but must instead be absorbed by the stockholders. The Commission, in the Salem case, among others, has found that personal use of a company vehicle does not produce a benefit to the ratepayers, and Lewisport has failed to demonstrate a benefit in this instance. Therefore,

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32 Application, Schedule 10.(11)(6)(a), page 18 of 42.

33 Hearing Data Request, Item 4.

test-year operating expenses have been reduced by $717[34] to remove costs associated with the manager's personal use of a company-provided vehicle.

Rate Case Expense

In its application, Lewisport proposed an adjustment of $10,000 to reflect a three-year amortization of the estimated $30,000 cost of processing this case. Subsequently, Lewisport revised its projected estimate to $33,796[35] and then to $53,250.[36] In its filing of January 24, 1994, Lewisport reported actual rate case expenses of $61,200. Lewisport proposes to include the amortization of this amount in its cost of service.

Lewisport based its initial $30,000 projection on expenses incurred prior to and through the hearing in the Salem rate case.[37] Lewisport attributes the increased expenses to new filing requirements in the Commission's regulations, placed in effect subsequent to the Salem case.[38]

The magnitude of Lewisport's rate case expense is not reasonable in relation to the size and scope of its operation. Lewisport's claimed level of expense is well above recent per customer rate case expenses experienced by other jurisdictional

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34 September 24, 1993, Data Request, Item 12.

35 September 24, 1993, Data Request, Item 17.

36 Transcript of Evidence, page 150.

37 Id.

38 Id.

companies.[39] Therefore, the Commission has carefully reviewed the record in this case to evaluate the reasonableness of Lewisport's proposed rate case expense. Only those rate case expenses which are considered reasonable and in line with those charged in other proceedings of similar complexity may be passed on to a utility's ratepayer. In the Salem case, the actual rate case expenses incurred prior to rehearing were $27,988.[40] The Commission allowed full recovery of these expenses; therefore, Lewisport's original estimated expense of $30,000 is more reasonable. Lewisport attributes the difference between its expense and Salem's primarily to the change in filing requirements, and also mentions data request requirements as a contributing factor.[41] This explanation is inadequate. While the new requirements are indeed more extensive than those in effect at the time of the Salem case, this was known when Lewisport filed the present case. It is unlikely that the new filing requirements, which were known at the time of the filing, were not factored into the original estimate. The data request requirements did not exceed the levels which occurred in

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Case No.	Utility	Customers	Expense	Exp/Cust
93-111	Belfry Gas	617	6,312	10.23
92-560	Salt River	26,115	20,590	0.79
92-452	KY-American	82,411	288,000	3.49
93-112	Boone Co. SD	4,486	11,913	2.66
93-300	Elk Lake WD	312	2,500	8.01
93-133	Lewisport	1,094	61,200	55.94

40 Salem Order, page 18.

41 Transcript of Evidence, page 150.

the Salem case and are an inadequate explanation for the excessive expense incurred in this case.

As Lewisport has not justified its reported actual rate case expense of $61,200, this expense is allowed at the original level of $30,000, to be amortized over three years.

ADJUSTMENTS SUMMARY

Based on the foregoing adjustments, the Commission finds Lewisport's adjusted test-period operations to be as follows:

	Test Year Actual	Adjustments	Test Year Adjusted
Operating Revenues	$682,727	$30,808	$713,535
Operating Expenses	578,277	14,561	592,838
Income Taxes	30,309	<17,647>	12,662
Net Operating Expense	$ 74,141	$33,894	$108,035

COST OF CAPITAL

Capital Structure

Lewisport's proposed capital structure of 17.73 percent equity and 82.27 percent long-term debt should be adjusted to reflect only the $1,192,000 of actual drawdowns of a REA loan as opposed to the projected $1,777,695 of drawdowns, as proposed by Lewisport. The resulting capital structure is 21.83 percent equity and 78.17 percent long-term debt.

Cost of Long-Term Debt

Lewisport's proposed cost of long-term debt includes projected drawdowns of $1,777,695 on a REA loan. As of October 1, 1993, actual drawdowns were $1,192,000. The actual drawdowns should be used in calculating the cost of long-term debt, as well as in determining the appropriate capital structure. The embedded cost of long-term debt should be 4.63 percent rather than Lewisport's proposed 4.72 percent.

Cost of Common Equity

Lewisport proposed a return on equity ("ROE") of 12.25 percent. It provided no financial analysis to support its proposal, but referred instead to the relatively large proportion of debt in its capital structure when compared to another TDS affiliate, Salem Telephone, which was granted a 12 percent equity return in 1992.[42] Lewisport shares with Salem the benefit of a parent corporation with greater access to the capital markets.

The Commission, having considered all of the evidence, including current economic conditions, finds that the cost of common equity is within a range of 11.75 percent to 12.25 percent. Within this range, an ROE of 12.0 percent will best allow Lewisport to attract capital at a reasonable cost and maintain its financial integrity to ensure continued service and to provide for necessary expansion to meet future requirements.

Cost of Capital Summary

Applying the approved capital structure to the approved capital costs yields a weighted average cost of capital of 6.24 percent.

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[42] Case No. 91-217, Adjustment of Rates of the Salem Telephone Company, Inc., Order dated February 28, 1992.

REVENUE REQUIREMENTS

Based upon the Commission's adjustments, Lewisport has a revenue deficiency of $65,502, determined as follows:

Net Investment Rate Base	$2,384,224
X Rate of Return	6.24%
Required Operating Income	148,776
- Adjusted Operating Income	108,035
NOI Deficiency	40,741
X Tax/Gross-Up	1.60778
Revenue Deficiency	$ 65,502

RATE DESIGN

Lewisport based its percentage increases for non-recurring charges, residential service, business service, and miscellaneous service on percentage increases which were determined when current rates were set. Non-recurring charges should ideally be based on the actual current cost to provide the service. While the method used by Lewisport is acceptable in the short run, Lewisport should, in subsequent rate cases, base non-recurring charges on actual costs.

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The rates in Appendix A, attached hereto and incorporated herein, are the fair, just, and reasonable rates to be charged by Lewisport for service rendered on and after March 1, 1994.

2. The rates proposed by Lewisport would produce revenue in excess of that found reasonable and should be denied based upon KRS 278.030.

3. The rate of return determined herein is fair, just, and reasonable and will provide for the financial obligations of Lewisport with a reasonable amount remaining for equity growth.

IT IS THEREFORE ORDERED that:

1. The rates in Appendix A, attached hereto and incorporated herein, be and hereby are approved for service rendered by Lewisport on and after March 1, 1994.

2. Within 30 days from the date of this Order, Lewisport shall file with the Commission its revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky this 1st day of March, 1994.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 93-133 DATED MARCH 1, 1994

The following rates and charges are prescribed for the customers in the area served by Lewisport Telephone Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

Monthly Rates

Residence One Party	$ 9.15
Business One Party	19.90
Key Trunk Line	28.00
PBX Line	29.30
COCOT	23.54
Semi-Public Telephone	25.54
Directory Listings	
Residence	1.00
Business	1.00
Non-Published Numbers	2.00
Service Connection W/Premise Visit	
Residence	32.00
Business	34.60
Initial Service Order Charge	
Residence	12.40
Business	18.80