COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

ADJUSTMENT OF RATES OF GENERAL TELEPHONE COMPANY OF KENTUCKY	)))	CASE NO. 8859

O R D E R

On July 15, 1983, General Telephone Company of Kentucky ("General") filed its notice with the Commission seeking to increase its rates and charges to produce an annual increase in revenues of $31,342,362 which was later amended to $25,522,187. On January 4, 1984, the Commission issued its Order granting an annual increase in revenues of $3,894,169. On January 23, 1984, General filed its application for rehearing of several issues. On January 31, 1984, the Attorney General ("AG"), through its Consumer Protection Division, filed its response to General's application. The issues thus raised will be addressed as follows:

Adjustments to Out-of-Period Capital

In its Order of January 4, 1984, the Commission included authorized issuances of $10,000,000 of new common equity and $25,000,000 of new long-term debt in identifying the relative percentage and weighted cost rate of various components of General's end-of-test period capital levels. The Commission's finding that the new equity and long-term debt were known and measurable related only to the issuance of the above items, which required prior approval from this Commission, and not to the prospective impact that such issuances may have on General's operations. The Commission has traditionally limited for rate-making purposes a utility's investment in either plant in service or capital to the end-of-period levels already being experienced by the utility. To include out-of-period adjustments which do not reflect the effects of the proposed adjustment on local service revenues, expenses and changes in productivity would violate the matching concept and in addition would not meet the Commission's criterion of being known and measurable for determining revenue requirements since projected effects on revenues, expenses and changes in productivity would be speculative and the inclusion of such out-of-period adjustments could result in the utility being permitted the ability to achieve earnings in excess of the return found to be fair, just and reasonable by the Commission. Therefore, General's request for rehearing on this issue should be denied.

Non-Utility Investment

General stated in its application that the Commission's treatment of non-utility investment was not consistent with the Commission's accounting procedures required in Case No. 8258, Application of General Telephone of Kentucky for an Order Implementing a Direct Sales Program Relating to its Single Line

Telephone Instruments. The Commission upon reconsideration of this issue has determined that a formal rehearing will not be required; however, the Commission will allow General to file test period financial data to verify the inclusion of any carrying charges on non-utility investment accounted for above the line in miscellaneous revenues. This data should contain as a minimum a thorough breakdown of miscellaneous revenues by component and the calculation of any carrying charges on non-utility investment included in miscellaneous revenues.

Out-of-Period Additions to Plant in Service

General stated in its petition for rehearing that the contracted out-of-period additions to plant in service were known and measurable at the time the Commission's Order was entered and that the associated revenues were readily determinable by the Commission.

The Commission set out on page three in its Order of January 4, 1984, the reasons for this disallowance of out-of-period additions to plant in service which were:

> that the results of this type of adjustment with the use of historical test period are speculative and thus do not meet the Commission's criterion of being known and measurable since the inclusion of out-of-period additions to the rate base even with offsetting income adjustments could result in General being permitted the ability to achieve earnings greater than the return found fair. . ..

In addition General's witness, Mr. John P. Blanchard:

> stated that it would be appropriate to further adjust this proposed increase to intrastate net

> operating income to reflect the rate of return granted by this Commission. Thus, the income effect would be zero and the adjustments would produce no additional revenue requirements. (Footnote omitted.)[1]

Therefore, the Commission's action has no adverse effect on General's being able to earn the return allowed. The adjustment did raise the concerns expressed by the Commission in its Order and restated above, which the Commission still finds to be a valid and legitimate basis for denial of the proposed adjustment. Therefore, rehearing on this issue should be denied.

Wage Adjustment

In its application for rehearing, General expressed its concern over the Commission's disallowance of certain wage increases stating that the predominant part of the unrecognized wage increases denied had already occurred or would occur within 4 months after the issuance of the Commission's Order in this case; that the increases were committed to in 1982 or early 1983 based upon existing conditions at that time; and that without recognition of the wage increases General will be unable to earn its allowed rate of return.

The Commission addressed these issues in great detail in its original Order of January 4, 1984. The wage increases proposed were projected for as far as 12 months past the end of

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1 Commission's Order in Case No. 8859, issued January 4, 1984, page 3.

the test period. The proposed increases did not reflect any increased efficiency or employee reductions on the part of General despite considerable testimony by General's witnesses on expected increased efficiency. The economic conditions in the Commonwealth for 1982 and 1983 (the period when the 8 percent salary increases for headquarters personnel, the 9 percent increases for support management personnel, the 7 percent increase for International Brotherhood of Electrical Workers and Communication Workers of America employees and the 8 percent increase for management personnel, in addition to step increases for non-management personnel, were committed to by General) showed unemployment levels which often equaled or exceeded 10 percent, and inflation rates for 1982 and the first quarter 1983 of only 3.88 percent and .96 percent.[2] As stated on page 15 in its Order the Commission continues to be of the opinion that "as a surrogate for the marketplace, the Commission must insure that the utilities under its jurisdiction are not insulated from economic conditions at the expense of Kentucky ratepayers."

The Commission is, therefore, of the opinion that General has failed to present sufficient reasons for a rehearing of the issue or new information which the Commission has not previously considered and addressed in its Order of January 4, 1984. Therefore a rehearing of this issue should be denied.

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2 CPI - Workers index.

Station Connections

In disallowing the proposed adjustment for the flash-cutting of station connection expensing, General contends that the Commission did not fully reflect the effect this disallowance had on net income. General did not state how the Commission failed to reflect the full effect the disallowance had on net income. In rejecting this proposed adjustment, the Commission reversed the proposed adjustments made by General to its net investment rate base, revenues, expenses, and net income. Therefore, the Commission has fully reflected the net income effects as calculated by General.

General provided no matching of its proposed adjustments and that portion related to Phase III. Phase III of the station connection expenses was granted by Order on September 30, 1983, in Case No. 8045, Adjustment of Rates of General Telephone Company of Kentucky, which allowed $441,142 in additional net operating income. In the computation of Phase III, as in all previous phases of expensing station connections, the concurrent reduction in required income due to the reduction in rate base was determined and used to offset the expense portion of the phasing adjustment. In the proposed flash-cut treatment General had reduced its rate base by the estimated effect of both Phase III and IV of the station connection changes.[3] The Commission's

[3] Prefiled testimony of Norman E. Newton, pages 3 and 4.

Order restored the rate base to the end-of-test-period levels of April 30, 1983, without reflecting the full consideration of expensing station connections. Not only would a reduction to rate base for Phase III have reduced the allowable income in this case had a concurrent adjustment to rate base been made, but such an adjustment would have been inappropriate as Phase III was calculated using a different test period than the one used in this general proceeding. Thus, no matching between this proceeding and Phase III occurs. Moreover, General will be granted the opportunity, based on its absorption potential, to recover Phase IV of the expensing of station connections at the appropriate time. The Commission finds no inconsistency in its treatment of expensing for station connections for General. The Commission, however, does advise General to provide more complete and detailed information of changes in investment and related net operating income in its Phase IV filing for the expensing of station connections. The Commission hereby denies General application for rehearing of this issue.

Job Development Investment Credits ("JDIC")

In its Order the Commission recognized General's disagreement with the Commission's methodology in assigning the overall cost of capital to JDIC. Since this matter is currently before the Kentucky Court of Appeals, the Commission will disallow General's request for rehearing of this issue. Should the court ruling not be favorable to the Commission's position, the issue of JDIC will be addressed as stated in the Commission's Order of January 4, 1984.

Risk Premium Analysis

General argued in its application for rehearing that the Commission was not well advised to disregard the risk premium analysis presented as evidence. General stated that Judge Greene expressly approved the underlying rationale of risk premium analysis as an undisputed "given." In the case of United States -v- Federal Communications Commission, Judge Greene reviewed a Federal Communications Commission ("FCC") rate case order for American Telephone and Telegraph interstate toll. His opinion incorporated an in-depth analysis of the FCC's reliance on a risk premium analysis. General stated that risk premium evidence was relevant in that case and is relevant in this case.

In Case No. 8045 extensive testimony was presented regarding the validity of the risk premium analysis. Ben Johnson, witness for the AG in Case No. 8045 stated that the cost of debt and the cost of equity did not appear to move together in any consistent fashion.[4] He also observed wide fluctuations in the spread between common equity returns and bond yields, from month to month, from quarter to quarter and from year to year.[5] As stated in the Order for Case No. 8859, General's own witness,

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4 Johnson rehearing testimony, Case No. 8045, page 7.

5 Ibid.

Mr. Jerry L. Austin, agreed at the hearing that the risk premium was highly volatile.

Dr. Caroline Smith, witness for the AG in Case No. 8859, stated that the cost applicable to debt and equity investments do not necessarily change in the same way at the same time.[6] She also noted that Federal Energy Regulatory Commission had rejected the proposition that a risk premium analysis was appropriated in all financial markets.[7] According to Dr. Smith, most state regulatory commissions have rejected the risk premium analysis either implicitly or explicity.[8] Clearly, this Commission is not alone in its opinion regarding the validity and usefulness of the risk premium analysis.

The Commission did not disregard General's risk premium analysis on theoretical grounds. Rather, from a practical standpoint, the Commission is not convinced that an accurate ex-ante risk premium can be determined, given the volatile nature of historical risk premiums. Applying an historical average risk premium to current bond yields to determine the cost of equity does not recognize current market conditions. This can lead to misstating the investor required cost of equity. Therefore, after considering all of the evidence, the Commission should deny

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6 Smith testimony, Case No. 8859, page 44.

7 Ibid., pages 46 through 47.

8 Ibid., page 45.

General's request for a rehearing on the issue of the risk premium analysis.

FINDINGS AND ORDERS

The Commission, after examining the evidence of record and being advised, is of the opinion and finds that:

1. All issues for rehearing should be denied with the exception of Item II relating to non-utility investment, which should be granted.

2. General should file a breakdown of its proposed miscellaneous revenue and any calculations supporting its claim that non-utility revenue is included therein.

3. All provisions of the Commission's Order of January 4, 1984, not specifically adjusted herein should remain in full force and effect.

IT IS THEREFORE ORDERED that General shall file the financial data as set out in Finding No. 2 above.

IT IS FURTHER ORDERED that General's application for rehearing be and it hereby is denied in part and granted in part, in accordance with Finding No. 1 above.

IT IS FURTHER ORDERED that all provisions of the Commission's Order in this proceeding issued January 4, 1984, not specifically amended herein shall remain in full force and effect.

Done at Frankfort, Kentucky, this 13th day of February, 1984.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary