COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

SEPARATION OF COSTS OF REGULATED TELEPHONE SERVICE FROM COSTS OF NONREGULATED ACTIVITIES	)))	ADMINISTRATIVE CASE NO. 321

O R D E R

On April 17, 1986, the Federal Communications Commission ("FCC") released its Notice of Proposed Rulemaking in CC Docket 86-111[1] to initiate comments and investigate methods of separating the costs of regulated telephone service from the nonregulated activities of telephone companies and their affiliates. The FCC released its Report and Order in this proceeding on February 6, 1987, and its Memorandum Opinion and Order on Reconsideration on October 16, 1987.

In the instant proceeding the Commission will investigate the need for procedures for separating costs of regulated telephone service from the nonregulated activities of Kentucky telephone companies and their affiliates. This Order is issued to all local exchange carriers (LECs), AT&T and other parties of interest as a means of gathering testimony and generating information and

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1 Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities.

Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to Provide for Nonregulated Activities and to Provide for Transactions Between Telephone Companies and Their Affiliates.

comment on the items included herein. The requested responses shall be filed by February 1, 1988. If the information cannot be provided by this date, a motion for extension of time should be filed, stating the reason a delay is necessary and a date by which the information can be furnished. Such motion will be considered by the Commission. Include with each response the name of the witness who will be responsible for responding to questions relating to the information provided and for responding to cross-examination at any hearings.

BACKGROUND

With the emergence of competition in traditionally regulated telecommunications services and entry of telephone companies into nonregulated markets, the FCC initiated its First Computer Inquiry Computer I.[2] In Computer I, the FCC declined to regulate data processing services and required that regulated entities were to provide data processing through structurally separate subsidiaries. Also, carriers were not allowed to promote or sell the data services of their subsidiarities, or to lease or sell spare data processing capacity to their subsidiaries. Thus, under Computer I requirements, the FCC sought to control potential

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2 Regulatory and Policy Problems Presented by the Interdependence of Computer and Communications Services and Facilities, Tentative Decision, 28 FCC 2d 291 (1970); Final Decision and Order, 28 FCC 2d 267 (1971), aff'd sub nom. GTE Service Corp. v. FCC, 474 F.2d 724 (2d Cir. 1973); decision on remand, 40 FCC 2d 293 (1973).

misallocation of costs through forbidding carriers from engaging in joint operations.[3]

As a result of technological innovation, Computer I distinctions became blurred and in the Second Computer Inquiry or Computer II,[4] the FCC established a new regulatory framework. Computer II distinguished between "basic" and "enhanced" services, and required carriers to unbundle their basic and enhanced service offerings. In addition, Computer II deregulated enhanced services and customer premises equipment at both the federal and state level. In order to control potential misallocation of costs, Computer II required separate subsidiaries for AT&T and the Bell Operating Companies ("BOCs") in providing enhanced services and customer premises equipment. Other carriers were allowed to offer enhanced services and customer premises equipment without separate subsidiaries. The Fifth Report and Order[5] in Computer II

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3 United States v. Western Electric Co., 1956 Trade Case. 71, 134 (D.N.J. 1956). Computer I requirements did not apply to AT&T or the Bell system subsidiaries since it was believed the Bell companies were barred from offering such services under the 1956 Consent Decree.

4 Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), 77 FCC 2d 384, modified on recon., 84 FCC 2d 50 (1980), further modified on recon. 88 FCC 2d 512 (1981), aff'd sub nom. Computer and Communications Indus. Ass'n v. FCC, 693 F.2d 198 (D.C. Cir. 1982), cert. denied 461 U.S. 938 (1983), aff'd on second further recon., FCC 84-800 (released May 4, 1984).

5 Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), Fifth Report and Order, CC Docket No. 81-893, FCC 84-547, 49 Fed. Reg. 46378 (Nov. 26, 1984).

established separate accounts for the nonregulated activities of telephone carriers without separate subsidiaries. Fully distributed costing was required to assign costs to nonregulated accounts for carriers other than AT&T, the BOCs, and those carriers exclusively subject to intrastate jurisdiction.

Computer III or The Third Computer Inquiry[6] was initiated to investigate structural separation requirements. It eliminated such requirements on AT&T and the BOCs and replaced them with nonstructural safeguards, including conformance with cost allocation procedures set forth in CC Docket No. 86-111.

In the February 6, 1987, Report and Order in CC Docket No. 86-111, the FCC established cost allocation standards for separating the costs of regulated and nonregulated activities for all local exchange carriers and dominant interexchange carriers. In that Order, the FCC did not require states to adopt its rules for intrastate rate-making purposes. However, on its own motion, the Commission has initiated this proceeding to evaluate such rules for intrastate purposes.

At this time, pending further Orders of the FCC in this matter, the Commission adopts for intrastate use on an interim basis the cost allocation manuals as filed with the FCC effective January 1, 1988. The telephone companies are hereby notified that any modifications made pursuant to this investigation will be

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6 Amendment of Sections 64-702 of the Commission Rules and Regulations. (Third Computer Inquiry), (CC Docket 85-229), Notice of Proposed Rulemaking, 50 Fed. Reg. 33581 (Aug. 20, 1985), see also, from the same Inquiry, Report and Order, Phase I, 104 FCC 2d 958 (1986) (Phase I Order).

deemed effective January 1, 1988. In the event the FCC does not approve the proposed manuals by January 1, 1988, the Commission reserves the right to modify this Order.

COST ALLOCATION STANDARDS

Among the Commission's goals is to insure fair, just, and reasonable rates for Kentucky ratepayers. Since cross subsidies can result from misallocation of common costs, the Commission must evaluate and be assured that Kentucky ratepayers are paying only for the regulated share of services provided by the telephone company.

The FCC has gone through an extensive evaluation of various allocation procedures in adopting fully distributed costing. The methodology adopted by the FCC is not intended to set prices for nonregulated activities, but merely to be used as a means of assuring that cross subsidies do not occur.

The cost allocation plan adopted by the FCC is based on direct and indirect links to regulated and nonregulated activities. Its standards, restated to reflect modifications arising from its Order on Reconsideration, are as follows:

(a) Carriers required to separate their regulated costs from nonregulated costs use the attributable cost method of cost allocation for such purpose.

(b) In assigning or allocating costs to regulated and nonregulated activities, carriers shall follow the principles described herein.

> (1) Tariffed services provided to a nonregulated activity will be charged to the nonregulated activity at the tariffed rates and credited to the regulated revenue account for that service.
>
> (2) Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

(3) Costs which cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy:

(i) Whenever possible, common cost categories are to be allocated based upon direct analysis of the origin of the costs themselves.

(ii) When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another cost category (or group of cost categories) for which a direct assignment or allocation is available.

(iii) When neither direct nor indirect measures of cost causation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.

(4) The allocation of central office equipment and outside plant investment cost between regulated and nonregulated activities shall be based upon the relative regulated and nonregulated usage of the investment at the highest forecast relative nonregulated usage over a uniform forecast period of three years.[7]

Questions

1a. Should the Commission adopt the same rules for cost allocation and affiliate transactions as the FCC?

1b. Do you prefer another method of cost allocation? If so, fully describe.

2. List and provide descriptions of all nonregulated activities.

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7 Report and Order, CC Docket 86-111, February 6, 1987, pp. 78-79 and Order on Reconsideration, CC Docket 86-111, October 16, 1987, pp. 3-6.

3. What amount of nonregulated revenue did your company have for 1986?

4. Does your company anticipate any revenue requirement impacts from the implementation of the FCC's cost allocation and affiliate transaction rules? If so, describe the impacts and state amounts.

5. For multi-jurisdictional companies, should cost allocations occur on a company wide or state specific basis? If company wide, explain procedures used in determining state allocations.

6. How should the costs of implementing such procedures be accounted for (i.e., regulated and/or nonregulated)?

7. For those companies filing manuals with the FCC, indicate the status of the manuals and if other filings have been made in the proceeding, provide copies of such filings as well as indicating the status of such filings.

8. Do you agree that if the Commission adopts allocation methodologies for separating regulated and nonregulated activities, possible accounting changes for CPE and inside wire and other detariffed items may be required?

Applicability to Small Telephone Companies

The Commission is concerned with the magnitude of requirements indicated in this a proceeding. Although the FCC has exempted average schedule companies from all cost allocation requirements,[8] the Commission is of the tentative opinion that some requirements should apply for intrastate purposes. Therefore, this

[8] Order on Reconsideration, October 16, 1987, p. 18.

investigation will also consider cost allocation procedures for NECA and intrastate average schedule companies.

The FCC cost allocation procedures are required for all LECs and dominant interexchange carriers which develop actual cost through cost studies. Although not Tier I LECs[9] by the FCC's definition in Kentucky, for the purposes of this investigation, the Commission will consider Continental Telephone of Kentucky and Alltel Kentucky, Inc., subject to the FCC's requirements as they have significant opportunnity to engage in nonregulated lines of business.

Questions

9. Should rules apply equally to those companies using NECA average schedule rates?

10. Should the Commission require cost allocation manuals to be filed for all dominant interexchange facilities based carriers and LECs in Kentucky? If not, what should be used as the determinant and how could the Commission be assured proper allocation procedures were being followed?

SPECIFIC ISSUES

Activities Detariffed on an Interstate Basis Only

Certain activities of a telephone company may receive different jurisdictional regulatory treatment. As such, the Commission will address these activities. The FCC has stated that activities that are deregulated at the interstate level but are not preemptively

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9 LEC's that earn more than $100 million in total company regulated annual revenues.

deregulated at the state level should continue to be accorded regulated accounting treatment.

Questions

11. Should the Commission follow this approach if it adopts such cost allocation rules?

12. The FCC has cited billing and collection services as an example of such activities. Do you agree that billing and collection services and other such activities not deregulated at the intrastate level, but deregulated at the FCC level should be accorded regulated accounting treatment? Explain.

13. Provide a list of activities that are deregulated/ detariffed on an interstate basis only.

Incidental Activities

"Incidental activities" are defined by the FCC as nontariffed activities which are logical outgrowths of regulated services and such activities have been accounted for as regulated activities, the activity is not a separate line of business and the activity is clearly identified in the cost manual. Revenues from these activities should produce, in the aggregate, no more than one percent of a company's total revenues.

The FCC has also expressed concern that only limiting revenues to only one percent may not adequately protect ratepayers in that underpricing may occur in initial stages of nonregulated activities. Therefore, the FCC has stated that it will also adopt qualitative guidelines to determine incidental activities.[10]

Questions

14. List and provide descriptions of all incidental activities. For these purposes, revenues from these activities should produce, in the aggregate, no more than one percent of a company's total regulated revenue.

15. Should the Commission adopt quantitative guidelines for incidental activities? If so, what measurement should be used?

16. Should qualitative guidelines be adopted in Kentucky to determine incidental activities: If so, what guidelines should be used?

17. The FCC has defined Yellow Pages and real estate speculation as separate lines of business that cannot be treated as incidental activities. How are these activities currently being accounted for (i.e., separate line of business)? Will this treatment remain the same upon implementation of the FCC's cost allocation standards?

Time Reporting

The Commission is studying the possible implementation of standards for time reporting. The FCC has found that there are no unique advantages for using either positive or exception time reporting. However, whichever approach is used, the FCC is requiring that time be reported in one hour or less increments.

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10 Order on Reconsideration, CC Docket 86-111, October 16, 1987, page 21.

These records are to be kept for a one-year period. There is also a concern for capturing nonproductive time, i.e. vacation, sick leave, etc. Documentation is required for these decisions in the manuals.

Questions

18. Provide descriptions of all in-place time reporting systems. Indicate whether time reporting is done on an exception or positive time reporting basis. Indicate time increments used and the manner in which nonproductive time is treated.

19. What increments should be used for time reporting?

20. How long should these records be maintained?

21. What procedures should be implemented by the Commission to assure accurate reporting of this time?

Marketing Costs

The FCC has recognized that marketing costs are unique in that most likely such expenses are incurred at a higher rate for nonregulated activities. The FCC has set up specific instructions to define marketing costs[11] to ensure that they are functionally related. It has further said that marketing costs which can be directly assigned are to be so treated, based on direct and surrogate measures. Residual costs are to be divided between the regulated and nonregulated activities based on the ratio for marketing costs already allocated.

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11 Report and Order, CC Docket 86-111, February 6, 1987, p. 95.

Questions

22. Should a separate allocator (other than the general allocator) be used for marketing costs? If so, how should it be calculated for intrastate purposes?

Depreciation Reserves

Depreciation reserves at the present time may present a unique allocation problem. The Commission questions the possible overallocation and underallocation of depreciation reserves to the regulated side. The FCC stated that the new Uniform System of Accounts adequately disaggregates plant for calculation of depreciation reserves.

Further, theoretical reserves (i.e. where deficiencies exist) are not permitted by the FCC for calculation of the reserve balances.

Questions

23. Should depreciation reserves of plant require greater disaggregation than subaccounts as prescribed by the new USoA to assure appropriate allocations of related expenses?

24. How should depreciation reserves be calculated to separate them between regulated and nonregulated activities?

Audits

One of the main issues involved in implementing such procedures is assuring that misallocations do not occur. Annual independent audits are required by the FCC for Tier I and dominant interexchange carriers for attestation of proper implementation of cost allocation manuals and to the accuracy of the carrier's cost allocations.

The Report and Order also specified that costs of auditing be allocated based on the general composite allocator.

Questions

25. Should independent attestation audits be required for Tier I and Tier II Kentucky carriers? If so, how often? If not, in what ways can the Kentucky Commission be assured these procedures are being followed (i.e. give examples of methods of enforcement)? What should be the determinant for requiring audits?

26. Should Commission staff be allowed access to the auditor's workpapers?

27. To what extent should Commission staff be allowed access to records (i.e., regulated and nonregulated)?

28. When should audits be implemented if required in Kentucky?

29. Should carriers be permitted to choose the auditors?

30. Where an auditor provides consultation regarding implementation of a manual or conducts the financial audit, should that same auditor be allowed to conduct the attestation audit?

Projected Usage of Investment Allocators

One of the FCC's cost allocation principles is that investment costs of central office equipment and outside plant facilities should be based upon the relative regulated and nonregulated usage of the investment at the highest forecasted nonregulated usage over a 3 year forecast period. If the forecast underestimates nonregulated use, then the regulated operations will bear costs that are actually being incurred for the benefit of nonregulated operations. Therefore, there is a large incentive for the carrier to underforecast its future nonregulated demand in order to avoid being allocated part of the risk of speculative investments. The FCC's solution is that if reallocations of plant from regulated to nonregulated operations are required, such plant will be transferred at undepreciated baseline cost plus an interest charge to reflect the time value of money. The FCC suggests that the interest charge serves two purposes. The first is to compensate the regulated operations for the time value of costs it bore for the nonregulated operations. The second is to reduce the incentive for the carrier to underestimate its future nonregulated demand. Transfers from nonregulated to regulated, as could occur if a nonregulated venture failed, would require a waiver.

The Commission is concerned that this method fails to accurately allocate the risk involved with major plant investments. Failure to allocate risk to nonregulated operations would result in ratepayers being unfairly required to bear the burden of a carrier's speculative investments. One difficulty with the FCC's method is that it is questionable whether the interest charge is sufficient to deter underforecasting of nonregulated demand. The FCC requires that the authorized interstate return in effect for each relevant period be used to compute the charge. However, ratepayers would have carried the burden of this investment in the rate base and, therefore, would have paid a return on this investment. To use this return as the interest charge merely provides a refund and does not appear to deter underforecasting.

Depending upon the interpretation of "undepreciated baseline cost", the inequity to the ratepayers is further pronounced if ratepayers are required to also carry the burden of maintaining equipment pending intended, but undeclared, nonregulated usage. The FCC defines "baseline cost" as either the depreciated original cost at the time of initial assignment or allocation of existing plant or the original cost of subsequently acquired new plant. This definition can be interpreted in various ways and should be clarified prior to implementing this method of allocation. For instance, a key phrase is "at the time of initial assignment or allocation". Based on these FCC definitions, if a carrier declares zero nonregulated projected usage for embedded equipment, and then later requires nonregulated use of the equipment, then "undepreciated baseline cost" could be interpreted as "undepreciated depreciated original cost". This definition has no meaning and should be clarified.

Another difficulty is the ease of circumventing the projected usage allocation method, since this is only one of the methods allowed. For instance, another method of allocation is to charge tariffed rates for tariffed services provided to a nonregulated activity. Both GTE and CBT have indicated in their cost allocation manuals that usage forecasts are unnecessary at this point since their deregulated operations use either dedicated, and therefore directly assigned, facilities or are provided under tariff. Both indicate if future requirements dictate that shared network facilities be allocated based on forecasted usage, then forecasts will be made. However, there are reasons to doubt that shared network facilities would ever be allocated based on forecasted usage, since there would be an incentive to create new tariff elements as required by nonregulated operations. This incentive is the avoidance of the assignment of risk inherent to the projected usage method. In fact, if the assumption is made that nonregulated operations are competitive, there may be significant external pressure for the creation of tariff elements. The end result is that nonregulated operations only bear costs as they become successful, thereby insulating them from the risk of the investment.

Question

31. How should a failure of a non-regulated activity to pay for its fully allocated costs be handled for telephone cooperatives in order to insure that regulated ratepayers do not pay for such failure?

32. When new investment is necessary in common plant, should the Commission require the LEC to allocate cost on the highest forecasted demand?

(a) If the Commission requires the allocation based on highest forecasted demand, what information should the Commission require to insure the accuracy of the demand forecast?

(b) If the Commission requires the allocation based on highest forecasted demand, should the Commission consider penalizing the nonregulated affiliate for under forecasting?

33. In economic studies provided to the Commission by the LEC for justifying new investments should the Commission require the expected cash flow for both the regulated and nonregulated revenues? If a study requires nonregulated revenue to show economic benefits, how should the Commission consider these revenues in evaluation of its investment plans?

34. How do you interpret "undepreciated baseline cost" for embedded equipment?

35. In the event of a future decision to move to the nonregulated segment of the business embedded equipment previously placed in service solely for regulated service, what accounting treatment will be provided with regard to your interpretation of "underpreciated baseline cost"?

AFFILIATE TRANSACTIONS

Finally, the Commission must evaluate transfers and/or transactions between the telephone company and its affiliates to be assured that proper valuations are made. The FCC has provided that all transactions between regulated and nonregulated entities be recorded at market value. Price lists or tariffs are to be used for determining market values. If such prices are undeterminable, when an asset is transferred from a regulated to a nonregulated activity, the higher of cost or fair market value shall be used to record the transaction. If the transfer is from a nonregulated to a regulated activity, it is to be recorded at the lower of cost or fair market value.

For services provided, the entity is to use the tariffed rate if it is a tariffed item. When shared services are provided to an affiliate that are not provided to unaffiliated entities, common costs are to be allocated between regulated and nonregulated operations.

Questions

36. How should transactions between affiliates be valued?

37. Should a return be allowed on such transactions?

38. Provide a list of all affiliates. For the purposes of this request, "affiliates" are defined as entities that directly or indirectly through one or more intermediaries, control or are controlled by, or are under common control with, the regulated operations of the utility. This is to include entities that engage in unrelated businesses such as cable television, real estate, right-of-way clearing, etc.

39. Identify all affiliates that engage or will engage in transactions with the regulated operations of the telephone utility, and describe the nature, terms, and frequency of such transactions.

40. If transactions between the regulated and nonregulated affiliates are based on the tariff rate of a service, what cost studies should the PSC require to ensure that the regulated company has been adequately compensated? Describe cost support and its methodology currently supplied to the Commission to support rate elements.

41. Does authorization for valuing transactions between regulated and nonregulated affiliates at tariff rates provide incentives for the LECs to file tariffs specifically designed for their nonregulated affiliates? Should the Commission adopt a

review process permitting other parties opportunity to comment on new tariffs and tariff elements? Should the Commission require the LEC to indicate whether an nonregulated affiliate will subscribe to a new tariff or tariff element when it is filed?

Allocation of Income Taxes

Allocation of income taxes represent a unique accounting treatment for regulatory purposes. The Commission must be assured that the telephone company receives the benefit of its tax credits and losses. The FCC has stated that "the income tax recorded by the regulated carrier would be the same as if it had been determined for the carrier separately. However, tax credits generated by carrier operations would be recorded by the carrier when used in the settlement of taxes by the affiliated group regardless of whether the carrier would have been able to use the credits itself as an independent entity during that period."[12]

Questions:

42. How should income taxes be calculated and allocated?

SUMMARY

IT IS THEREFORE ORDERED that (each LEC, AT&T) and other parties shall file responses to the questions enumerated in the text of this Order by February 1, 1988.

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12 Notice of Proposed Rulemaking, CC Docket 86-111, April 16, 1986, para. 78, p. 39, and Report and Order, CC Docket 86-111, February 16, 1987, p. 139.

Done at Frankfort, Kentucky, this 29th day of December, 1987.

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.
Chairman

Robert M. Davis
Vice Chairman

George W. Williams, Jr.
Commissioner

ATTEST:

Executive Director