

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

INVESTIGATION OF THE KENTUCKY)
INTRASTATE RATES OF SOUTH CENTRAL) CASE NO. 10105
BELL TELEPHONE COMPANY, INC.)

O R D E R

INTRODUCTION

Procedural Background

On December 16, 1987, the Commission initiated this investigation and review of South Central Bell Telephone Company, Inc.'s ("SCB") rates and charges pursuant to KRS 278.260. The investigation was begun because of the numerous changes impacting SCB, the telecommunications industry as a whole, and the economy since the conclusion of SCB's last rate case in May 1985.

In its December 16, 1987 Order, the Commission directed SCB to file a recent 12-month test period income statement, rate base, capital, and capital structure as well as propose any adjustments SCB deemed appropriate. Further, the Order stated that the Commission would consider an incentive regulation plan as part of the investigation.

The following have intervened in this proceeding: the Attorney General of the Commonwealth of Kentucky, by and through his Utility and Rate Intervention Division ("AG"); the Secretary of the Army on behalf of the Department of Defense ("DOD"); AT&T Communications of the South Central States, Inc. ("AT&T"); MCI

Telecommunications Corporation ("MCI"); GTE South Incorporated ("GTE"); Contel of Kentucky, Inc. ("Contel"); the Independent Telephone Group; and Combined Communications.

On January 20, 1988, SCB filed its response to information requested in the December 16, 1987 Order. On February 22, 1988, the Commission issued an Order finding that additional information would be required to analyze SCB's rates and charges and its proposed incentive plan and, therefore, established a procedural schedule affording opportunities for parties to participate in discovery, to hold informal conferences, and to conduct a hearing.

Subsequent to a phase of discovery, an informal conference was convened on April 20, 1988. The purpose of the conference was to allow all parties an opportunity to discuss information in the record and to discuss procedural matters. On April 20, 1988, SCB filed a motion to modify the procedural schedule established by the Commission in its February 22, 1988 Order.

On April 22, 1988, the Commission suspended the procedural schedule it had adopted in its February 22, 1988 Order, pending consideration of several motions, including SCB's motion to modify the procedural schedule.

During the pendency of these motions, on July 13, 1988, SCB filed a revision to its January 20, 1988 response and proposed incentive plan. This revised plan and accompanying tariffs, styled Motion of South Central Bell Telephone Company to Conclude this Docket and to Adopt Revised Incentive Plan, if accepted, would produce an annual benefit of \$20.4 million to the Kentucky ratepayers, consisting of a 3-year amortization of the

depreciation reserve deficiency of \$14.9 million and an initial reduction in local rates of \$5.5 million.

On July 15, 1988, the Commission established a procedural schedule for the purpose of allowing inquiry into the impact of SCB's motion and revised incentive plan ("Incentive Plan"). Such procedural schedule established an opportunity for filing comments on SCB's motion and Incentive Plan, for filing reply comments, and for a hearing to present testimony and argument concerning whether the motion should be granted or denied. The Commission amended the procedural schedule by Order dated July 20, 1988 to include a period of discovery.

Comments to SCB's proposal for an initial earnings reduction and Incentive Plan were filed by the AG, the DOD, AT&T, MCI, GTE, Contel, and the Independent Telephone Group. SCB filed reply comments. A hearing on SCB's July 13, 1988 motion commenced August 22, 1988 and lasted through August 24, 1988.

Appearing as witnesses were:

SCB	Stanley S. Dickson, Vice President, Kentucky Jerry Usery, Operations Manager - Financial Analysis
AG	Matthew I. Kahal, Exeter Associates, Inc. Thomas S. Catlin, Exeter Associates, Inc. Marvin H. Kahn, Exeter Associates, Inc.
AT&T	L. G. Sather, Staff Manager - Marketing Plans Implementation
MCI	Mike Ozburn, Director of State Regulatory Policy
GTE	Norman L. Farmer, Revenue Programs and Industry Affairs Director
Contel	Orville Douglas Fulp, III, Revenue Requirements Manager

At the conclusion of the hearing, SCB agreed to defer the effective date of the proposed earnings reduction and incentive plan to October 1, 1988 to permit the filing of briefs and to allow further deliberation by the Commission. The proposal, if accepted, was to have been effective September 1, 1988.

The transcript of the 3-day hearing on SCB's motion was filed by August 29, 1988. SCB, the AG, the DOD, AT&T, MCI, and Contel filed post-hearing briefs.

South Central Bell's Proposal

SCB proposed in its July 13, 1988 motion that the investigation be concluded by the Commission's adoption of the following experimental plan: a) a current rate reduction in local service rates with an annual revenue requirement impact of \$5.5 million; b) the amortization of the depreciation reserve deficiency to be booked over a 3-year period with an annual revenue requirement impact of \$14.9 million; c) an incentive regulation plan under which SCB will share with the Kentucky ratepayers the benefits of earnings above a specified range of average return on capital and the risks of earnings below the specified range; d) the plan, as proposed, would extend through August 31, 1990, during which time SCB will not request to implement any general increases in local exchange rates to be effective prior to the end of the plan.

Therefore, the initial combined benefit to Kentucky ratepayers of the \$5.5 million local rate reduction and the amortization of the depreciation reserve deficiency would be \$20.4 million.

Under the proposed plan, SCB would file a report of its earnings on May 1, 1989, November 1, 1989, and May 1, 1990. In response to the proposal of the AG, SCB has offered an additional point of test to be filed on November 1, 1990.

SCB's trigger for sharing the benefits and risks with ratepayers is the established range of return on capital, adopted in Case No. 9160, An Adjustment of Rates of South Central Bell, Inc. The specifics of this sharing process will be discussed elsewhere in this Order.

Summary of this Order

As a result of this review and investigation of SCB's earnings, the Commission has an understanding of SCB's current operations, including its financial status and earnings level. Based on the record and a thorough examination of the Incentive Plan, the Commission, being advised, is of the opinion and finds that SCB's Motion to Conclude this Docket and to Adopt Revised Incentive Plan should be granted, with certain modifications.

Acceptance of the Incentive Plan should not be construed as committing the Commission to any specific principle contained in the plan which may have been accorded different regulatory treatment in the past. The Commission in making its decision is considering the entire proposal. The Commission's findings concerning the elements of SCB's proposals are discussed below.

ANALYSIS AND DETERMINATION

Advantages and Disadvantages of Incentive Regulation

In its Order establishing this case, the Commission stated it was "interested in addressing issues in a manner that will enhance

the long run interests of the ratepayers and the company."¹ The Order continued by saying the "Commission is, therefore, opening this investigation to include consideration of forms of incentive regulation. This will entail a review of plans and proposals related to rate stabilization or other nontraditional forms of regulation."²

In taking this action, we note that a number of other states throughout the country have initiated new directions in the regulation of the telecommunications industry. Programs range from the social contract concept used in Vermont to the sharing of returns in Wisconsin. In determining the advantages and disadvantages of incentive regulation, the Commission has reviewed the incentive regulation plans in other states, copies of which were filed in this docket by SCB.

In adopting an incentive regulation plan, the Wisconsin Commission stated that by "establishing this mechanism [range of rate of return from 12.5 percent to 15.5 percent], the Commission's goal is to provide a greater incentive for the company to be efficient and not simply to require the sharing of risk."³

The Wisconsin Commission, noting a potential disadvantage of incentive regulation, stated in its final order that "[d]uring the period of this range, the commission expects that the company will

1 Case No. 10105, Order dated December 16, 1987, page 4.

2 Ibid.

3 Final Order of Public Service Commission of Wisconsin, Docket 6720-TI-102, page 15.

maintain plant and equipment and continue to provide adequate present and future service."⁴

The New York Public Service Commission in extending the rate case moratorium for New York Telephone ("NYT") identified the following benefits:

"The moratorium represents a step toward regulation by incentive. NYT bears the risks of increased costs but retains the benefits of increased productivity and sales. NYT's financial success would be tied to the efficiency of its operations, just as in competitive industries. NYT would be able to devote greater energies to improving its service and efficiency, while PSC staff would be free to direct its attention to more creative aspects of regulation."⁵

In this statement, the New York Commission is identifying similar advantages to nontraditional regulation as Wisconsin in regard to more efficient allocation of company and commission resources. The New York Commission also recognizes the benefits of tying the company's financial success to its operating efficiency.

Moreover, the Alabama Commission has found that a major advantage to its rate stabilization plan for South Central Bell is the establishment of a process for continually monitoring the company in greater detail than was previously done between rate cases.

Many of the advantages identified by the New York and Wisconsin Commissions were also identified by SCB in Mr. Dickson's and Mr. Usery's testimony.

⁴ Ibid., page 16.

⁵ Commission Rationale, New York Telephone Company Rate Moratorium Extension, Case No. 28961, Opinion No. 85-17(D).

During the hearing, Mr. Dickson stated, "They [rate cases] take a lot of resources of the Commission, of the company, of all the parties that are involved in [them]. There has got to be a better way and I believe this [Incentive Plan] is the better way."⁶ Identifying additional advantages of the Incentive Plan, he stated that:

the ratepayers will share in the efficiency of the company when we are able to improve and bring our performance up, the ratepayers will share in it. It drives us to reduce cost. It drives us to apply technology properly and to be innovative and to increase productivity. It streamlines the regulatory process . . . and yet the Commission will still be able to monitor the company and its earnings."⁷

Mr. Dickson further stated that in his opinion, "it is time for a new approach to regulation in Kentucky in keeping with the rapidly changing nature of the telecommunications business."⁸

In Mr. Usery's testimony, he stated that, "[I]t [Incentive Plan] is still regulation. It is not a detariffing or deregulation plan. The Commission will retain all oversights and all statutory rights and privileges that it has today and always has had."⁹ Mr. Usery's statement is an important acknowledgement by SCB of the continued regulatory role of the Commission during the experimental period, including all statutory authority.

⁶ Transcript of Evidence ("T.E."), Volume I, page 26.

⁷ Ibid., pages 26 and 27.

⁸ Ibid., page 32.

⁹ T.E., Volume II, page 9.

In its review of the Incentive Plan, the Commission fully recognizes the potential advantages and disadvantages of implementing incentive regulation. The following are some of the potential advantages and disadvantages of the Incentive Plan submitted by SCB.

The Incentive Plan approach to rate-making eliminates the traditional rate case and sets up a system of automatic test points to increase or decrease rates. This reduces SCB's and parties' costs associated with rate cases. In a period of high earnings, such as the period SCB is now in, this mechanism can significantly speed up Commission action because it works automatically as opposed to investigatory actions that are slower. Moreover, regulatory lag between the end of the test period and implementation of a rate increase or decrease should be shortened.

The Commission believes another major potential benefit to incentive regulation is that it promotes efficiency through sharing and better allocation of resources. Thus, ratepayers should fare better than under traditional rate-making regulation. The Commission does want to emphasize, as Wisconsin has, that SCB's overriding goal should be to maximize operating efficiency and not to operate at levels that only share the risk with ratepayers. The Commission considers that Mr. Dickson's statements on the merits of the Plan constitute an obligation to make the operating efficiencies he spoke of a reality for the benefit of the Kentucky ratepayers. The Commission further emphasizes that this Plan is experimental and that the Commission

will review SCB's efforts and results in achieving greater efficiencies in its evaluation of incentive regulation.

The Commission views the additional monitoring and oversight of SCB's service quality and financial operations to be another potential advantage of incentive regulation. Not only will better standards be established, but continual monitoring will allow for a current dialogue with SCB. This should produce a better understanding of SCB's operations by the Commission and a better understanding of the Commission's goals by SCB. This understanding in turn should enable both the Commission and SCB to address problem areas with quicker intervention and more timely action.

Finally, the Commission believes that the initial reduction of \$20.4 million (approximately \$1.7 million per month) in the Incentive Plan is a very important benefit. A further delay in this proceeding would postpone this immediate reduction with no assurance that a greater decrease in rates would result. Although intervenors have presented arguments that the initial reduction should be greater, the Commission is convinced, for the reasons set forth herein, that the \$20.4 million rate decrease is reasonable and that this amount could not be significantly increased by extending the investigation.

A major concern with both the concept of incentive regulation and SCB's proposed Incentive Plan is that the experiment may permit SCB to recover excess profits without improvements in operating efficiency. The AG argues that investments already made in network facilities will permit SCB to enjoy reduced costs

regardless of SCB's efforts to improve efficiency. The AG contends that SCB is attempting to insure that ". . . the dividends from these efforts. . . not be returned to these captive ratepayers but rather to its stockholders."¹⁰ The Commission fully recognizes that this is a legitimate concern. However, the Commission has restricted the opportunity for this to occur by the adoption of an experimental plan with explicit time constraints. Furthermore, the Commission recognizes that regulatory lag already permits utilities in periods of high earnings to enjoy short-term above-normal profits; therefore, the Incentive Plan does provide a mechanism which will provide for financial reviews with a mechanism to ensure timely sharing of above-normal profits.

Another potential disadvantage of the Incentive Plan is the change in the Commission's traditional process of reviewing expenses and disallowing unreasonable and inappropriate items. Monitoring could uncover these unreasonable amounts, but the mechanism does not allow for adjustments unless SCB should choose to agree to an adjustment. To eliminate the effects of unreasonable or inappropriate expenses, after a given period of time, which in this case will be 2 years, the Commission should fully examine SCB's earnings in a formal investigation and make appropriate adjustments to SCB's tariffed rates.

The Commission is also concerned that a potential disadvantage to incentive regulation would be a decline in the quality of service. SCB has stated that this will not occur, and

¹⁰ Comments of the AG, page 6.

we consider this to be a commitment on SCB's part. To assure ratepayers that service quality does not decline, the Commission will monitor SCB's operations carefully during the period the Plan is in effect and will, if necessary, take corrective action. Service quality will also be evaluated in the determination of whether to continue incentive regulation beyond the experimental period.

The Commission does believe that the potential advantages outweigh the potential disadvantages; however, the Commission also recognizes that without actual experience in the operation of incentive regulation neither the advantages or disadvantages can be verified. This experimental Incentive Plan provides the Commission, SCB, and intervenors the opportunity to assess this method of regulation at minimal costs. Therefore, the Commission is of the opinion that the Plan as modified by the Commission should be adopted.

The Commission, in subsequent sections of this Order, will discuss the intervenors' specific disagreements with the Plan and the Commission's required modifications.

Initial Rate Reduction

In its motion to conclude the docket, SCB proposed to reduce basic local rates immediately by \$5.5 million and to amortize the depreciation reserve deficiency over a 3-year period beginning October 1, 1988 for an additional revenue requirement adjustment of \$14.9 million. The initial rate reduction of \$5.5 million was determined by applying the proposed Incentive Plan to actual unadjusted earnings of the 12-months ended October 31, 1987 and

sharing the earnings above the range prescribed in Case No. 9160. The \$14.9 million is SCB's proposal to recover its depreciation reserve deficiency through amortization as a result of its latest depreciation represcription. These two adjustments have the impact of reducing SCB test period earnings on capital to 11.25 percent.

In its comments on the Incentive Plan filed August 12, 1988, the AG expressed concerns about the initial level of rate reduction. Further, during the hearing, the AG's witness, Mr. Catlin, offered an exhibit to show SCB's potential initial reduction which used the actual earnings for the 12 months ending October 31, 1987, adjusted only for amounts the Commission would ordinarily require in a full rate case, e.g., interest synchronization, the earnings of BellSouth Advertising and Publishing Company ("BAPCO"), employee concessions, lobbying expenses, institutional advertising, interest during construction, and certain miscellaneous income deductions. The AG later submitted a typed version of the exhibit which used essentially the same method of deriving the initial reduction.

The Commission considers this approach one-sided. It's true that the Commission does require the above adjustments. However, in a traditional rate case, the Commission also normalizes the test period and permits adjustments for items that benefit the company. The AG's exhibit does not even reflect adjustments to the test period for Commission ordered changes such as adjustments for the Uniform System of Accounts, the effects of the federal tax changes or the changes in access charges.

SCB proposed that no adjustments be made in order to keep the Incentive Plan simple to implement. Although the Commission recognizes the AG's concerns, even the AG's witness, Mr. Catlin, agreed during cross-examination that to make all adjustments would unduly complicate the process.¹¹ In order to avoid complications, the Commission finds that during this 2-year experimental period, ease of implementation requires that no adjustments be made.

The Commission's decision not to require any accounting adjustments is not a change in policy for rate cases, but is merely a different approach in incentive regulation. It should also be noted that during the term of the Plan, an examination of SCB's earnings will continually be monitored under traditional rate-making procedures.

Initial Rate Adjustment Rate Design

As part of its Incentive Plan, SCB proposed to reduce local exchange and exchange related rates and service charges in the amount of \$5.5 million.

AT&T contended that at least a portion of the initial rate reduction should be applied to interLATA access charges.¹² Cross-examination during the public hearing also explored application of the initial rate reduction to intraLATA toll rates. These are the only alternatives to SCB's proposal addressed in the record of this investigation.

¹¹ T.E., Vol. II, pages 257 and 258.

¹² Prefiled Testimony of L. G. Sather, page 3 and Brief of AT&T, pages 3-4.

The Commission will accept SCB's proposed rates. In taking this action, the Commission notes that interLATA access charges were reduced approximately \$7.7 million, effective in January 1988.¹³ Furthermore, interLATA access charges may be reduced in the future as a result of rate adjustments based on cost of service, as a result of rate adjustments triggered under SCB's Incentive Plan, or as a result of annual access services tariff filings.

The Commission is also of the opinion that this rate reduction should be applied to local exchange access rates and service charges as opposed to intraLATA toll rates in order to immediately share the benefits with the majority of SCB's ratepayers.

Amortization of Depreciation Reserve Deficiency

As part of its Incentive Plan, SCB proposed a 3-year amortization of its depreciation reserve deficiency, to begin concurrently with the Incentive Plan and conclude 3 years thereafter. SCB filed its latest Depreciation Study in 1987, based on Plant-In-Service as of December 31, 1986. A "Three-Way" meeting was held in March 1987. Representatives of SCB, the Commission Staff, and Federal Communications Commission Staff participated in the meeting. The parameters (Life, Salvage, and Curve Shape) which were agreed upon at that meeting were based on all plant installed through December 31, 1986. Additionally,

¹³ Order in Case No. 8838, Phase IV, dated December 9, 1987.

consideration was given to SCB's modernization plan designed to provide all software-controlled central office equipment within its serving areas by August 1990. The reserve deficiency was calculated based upon the depreciation reserve which should have existed as of December 31, 1986 utilizing the agreed parameters.

The agreed parameters were made effective July 1, 1987 by the December 16, 1987 Order in Case No. 9923, Depreciation Rates and the Amortization of the Depreciation Reserve Deficiency of South Central Bell Telephone Company. A final decision on SCB's proposed amortization was deferred to this investigation, and the record in Case No. 9923 was incorporated into the instant matter in the above-referenced Order.

A reserve deficiency occurs when insufficient dollars are accumulated in the depreciation reserve account due to depreciation rates which, for whatever reason, have not matched the actual or estimated useful life of an asset or group of assets. The deficiency is usually measured by comparing the balance in the reserve account to the reserve requirement, utilizing the currently approved depreciation parameters to reflect the current environment of the class of plant being studied. SCB has requested to amortize this reserve deficiency by allocating a fixed amount to the appropriate expense accounts over a 36-month future accounting period.

After consideration, the Commission has determined that SCB should be allowed to amortize its reserve deficiency as part of its Incentive Plan. This approval should not be interpreted as a policy of general acceptance of depreciation reserve amortization

proposals, but is appropriate in this case. The amortization will benefit ratepayers since no rate increase will be required for its implementation, and SCB's rate base will be reduced by the amount amortized, resulting in a reduction of revenue requirement in the future. Therefore, SCB should recover its depreciation reserve deficiency of \$14.9 million per year over a period of 36 months beginning October 1, 1988.

Return on Capital

In both the original incentive plan filing and the July 13 motion, SCB has proposed using actual return on capital ("ROC") as the test measure for earnings. SCB contends that by using ROC, many of the disputes in determining the level of earnings will be minimized. None of the intervenors challenged the use of ROC. The Commission is of the opinion that ROC is a proper test measure for earnings and should be adopted.

In the Incentive Plan, SCB has proposed the range of 11.52 to 12.07 percent for ROC adopted in Case No. 9160 as the trigger for its sharing mechanism. The Plan as proposed contains four adjustment points with different sharing ratios in each of the ranges. Through the range of 12.07 to 13.57 percent, all earnings will be shared in the ratio of 50 percent by SCB and 50 percent by the ratepayer. All earnings in excess of 13.57 percent will be shared 25 percent to SCB and 75 percent to its ratepayers. This sharing would be in addition to the sharing occurring between the range of 12.07 percent and 13.57 percent. If earnings fall to between 10 percent and 11.52 percent, then SCB will calculate the amount required to adjust earnings to 11.52 percent. SCB will be

permitted to adjust rates to recover only 50 percent of that amount from its ratepayers. Finally, if earnings should fall below 10 percent, then SCB will calculate the amount required to bring earnings to 10 percent but will be allowed to adjust rates to recover only 75 percent of that amount from ratepayers. This would be in addition to the sharing between 10 percent and 11.52 percent. In support of the ROC range and sharing mechanism, SCB contends that the ". . .use of the currently authorized return on capital as one piece of the balanced package which provides benefits to all stakeholders in the plan."¹⁴ Further, SCB contends that ". . .the company is taking additional risk with the implementation of the plan."¹⁵

The AG, DOD, and MCI opposed adopting the ROC range included in the Plan. The AG argued that the adoption of the proposed ROC range is inappropriate and that at least three modifications should be made to ROC range before it is acceptable. First, the AG pointed out that since Case No. 9160 was concluded, there has been a decline in the cost of debt from 9.1 percent to approximately 8.8 percent. Thus, the actual cost of debt should be used and the ROC adjusted downward.¹⁶ Second, the AG contended that current market conditions require a reduction in the cost of equity. Third, the AG proposed to use the capital structure

¹⁴ SCB Brief, page 25.

¹⁵ Ibid., page 26.

¹⁶ AG Brief, pages 4 and 5.

adopted in Case No. 9160 of 55 percent equity and 45 percent debt. Finally, the AG argued that the Incentive Plan should be based on an ROC range of 10.3 percent to 10.6 percent.¹⁷

The DOD and MCI did not propose alternative ranges for ROC but instead contended that the Commission ". . . should proceed with the investigation it initiated in December 1987."¹⁸ Both DOD and MCI argued that a proper determination of ROC is necessary prior to adoption of an Incentive Plan.

The Commission in reviewing the proposed ROC and the sharing mechanism contained in the Incentive Plan considered it as a part of the total package proposed by SCB. The Commission realizes that in a rate case proceeding under traditional regulation, it may set ROC at some range other than that proposed by SCB, or for that matter, the AG. However, the Commission has examined the entire Incentive Plan, which included balancing all aspects of the proposal. Accordingly, as previously stated, the Commission also recognized the benefits resulting from the initial rate reduction and the amortization of the depreciation reserve deficiency. Therefore, the Commission concluded that the Incentive Plan, as modified, including the ROC and the adjustment mechanism is reasonable and, further, that the proposed ROC range is appropriate for initiating an experimental Incentive Plan.

¹⁷ Ibid., page 5.

¹⁸ DOD Brief, page 2.

Hypothetical Capital Structure

The AG in this proceeding proposed that an incentive plan for SCB should incorporate a hypothetical capital structure of 55 percent equity and 45 percent debt. The Commission has traditionally used this capital structure in SCB's rate cases.

There are only two means by which a hypothetical capital structure could effect the determination of appropriate earnings. One way would be the determination of an earnings requirement based on the return on equity rather than ROC, thus in effect setting a change in the range of returns on capital. The second way would be to make an adjustment for interest synchronization consistent with the hypothetical debt structure. None of the intervenors in this case advocated the use of the return on equity as opposed to ROC and the Commission, as stated previously, has accepted ROC as the method of earnings determination. Moreover, elsewhere in this Order the Commission has determined that adjustments to earnings for accounting adjustments will not be made. Interest synchronization is an accounting adjustment. Thus, the Commission has concluded that the use of a hypothetical capital structure is not necessary.

Force Majeure

SCB has included in its Incentive Plan a statement which contemplates that unforeseen events, whether physical or economic, may cause SCB or the Commission to reevaluate whether the proposal should be modified. Though approving the Incentive Plan, the Commission specifically reserves its statutory authority to act on SCB's rates in the event of unforeseen circumstances that, in the

Commission's opinion, have such a substantial impact upon the range of earnings or ROC stated in the plan as to render SCB's actual return unreasonable. The Commission asserts herein that its statutory responsibility may not be changed or lessened by the adoption of this Incentive Plan. In so stating, however, the Commission is not revising SCB's proposal, but merely expressing its statutory mandate.

Ratcheting

During cross-examination of Mr. Usery, an extensive number of questions were asked about adjustments permitted in the proposed Incentive Plan for prior periods. Examples were presented which illustrated scenarios of both underearnings and overearnings. It was revealed that the proposed Plan contained a mechanism which effectively could expand the range of authorized return on capital upward and downward for future periods. Simply put, any gains or losses by SCB would be deducted or added cumulatively to future earnings prior to a review of those future earnings. During the hearing, this cumulative impact was later coined a "ratchet."

The Commission is very concerned with the operation of the ratchet mechanism. Because of the way the ratchet operates, the range of returns prescribed by the Commission would change with each sharing. The Commission believes this is unreasonable and should not be permitted. The Commission therefore denies the ratchet mechanism as a feature of the Incentive Plan.

Refunds or Reductions

In the initial incentive plan filed January 20, 1988, SCB proposed to use a combination of rate reductions and credits to

share earnings above 12.07 percent ROC between customers and SCB. Of these benefits returned to ratepayers, SCB proposed returning one-half in the form of a credit to residence and business local exchange customers with the remaining in the form of rate reductions. SCB proposed to determine the amount of credit per customer at each point of test and to apply that credit in April and October of each year against the customer's monthly recurring charge. In addition, SCB indicated that if the total revenue benefit was less than \$500,000, then the entire benefit would be in the form of rate reduction. In its Incentive Plan filed July 13, 1988, SCB proposed to alter the refund/credit plan included in the original proposal by offering either refunds or credits as the adjustment to share earnings.

The AG in its prefiled comments, at the hearing and in its post-hearing brief, proposed that the Commission adopt both refunds and reduced tariffs assuming overearnings at a given point of test. The AG's witness, Dr. Kahn, stated at the hearing that an incentive plan should include both mechanisms in order to reflect "what takes place in a competitive market."¹⁹ The AG contended that a refund adjusts for SCB's overearning during the 6-month period and a rate reduction is to insure a similar overearning will not occur.²⁰

SCB objected to making both refunds and reductions. SCB's witness, Mr. Usery, stated that if the Commission chose to make

¹⁹ T.E., Volume II, page 273.

²⁰ Comments of the AG, page 17.

both refunds and reduce tariffs, the effect would be "almost punitive."²¹ However, SCB did continue to indicate its willingness to accept either refunds or credits as an adjustment mechanism. In its post-hearing brief, SCB did state, "[t]he use of rate reductions will help in achieving necessary pricing and rate design objectives that will be of long-term benefit to the company and its ratepayers as competition in the telecommunications marketplace increases."²²

The Commission has reviewed this issue extensively. While it appears reasonable to require refunds at a given point of test followed by tariff reductions to adjust earnings back to the top of the range, this would not necessarily parody competition. The tariff reduction following a refund would in 6-month's time have eliminated any shared profit for SCB. In a competitive environment, a company that introduces some efficiency, such as a new product or a cost-saving measure, can expect to retain above normal profits until its competitors adjust to the change in product mix or manufacturing process. Only after competitors are able to adjust, would prices be reduced to bring the innovative firm's profit in line with the competitors. This process generally occurs over a much longer period than 6 months.

Therefore, the Commission is of the opinion that the AG's proposal would not reflect what takes place in a competitive market but would instead prove to be a drawback to innovation and

²¹ T.E., Volume II, page 19.

²² SCB Brief, page 30.

to incentive. In fact, the Commission believes that under the AG's scenario, SCB would do better to rely on traditional rate cases.

Thus, the Commission will, for the 2-year experiment, not require both refunds and reductions. The Commission does recognize that periodically both a refund and rate adjustment may be appropriate to more accurately reflect how a market operates. Information gathered during the experiment will be analyzed and used to determine the timing of adjustments if the Commission should decide to go forward with this type of regulation.

On comparing the two, refunds return any sharing to ratepayers quickly, while tariff reductions are slower but do provide the advantage of being a more permanent pricing signal. The decision of whether to require refunds or reductions is also closely tied to the implementation of the rate design issues since technical problems associated with either method could impede its use. Therefore, the Commission will defer this decision for consideration in the proceedings on Schedules 3 and 4 of SCB's Incentive Plan.

Fourth Point of Test

The AG proposed a fourth point of test of earnings sharing under the Incentive Plan. SCB agreed to this modification. The Commission considers this modification necessary and will require that the Incentive Plan include a fourth point of test to be filed on November 1, 1990.

Rate Design

Schedules 3 and 4

SCB's Incentive Plan includes proposed Schedules 3 and 4. Schedule 3 is a priority ranking of rate decreases that might be triggered under the Plan. Schedule 4 is a priority ranking of rate increases that might be triggered under the Plan. Both schedules generated controversy and SCB has indicated willingness to defer a decision on the design of Schedules 3 and 4 to further investigation.²³ The rate design concerns raised by the interexchange carriers and the local exchange carriers at the hearing will be considered in any further proceeding. Therefore, the Commission will defer the design of Schedules 3 and 4 and issuance of a procedural schedule will be forthcoming.

Revenue Neutral and Flexible Tariff Filings

SCB's Incentive Plan includes the provision that:

. . . during the period of this plan the Company and the Commission will not be precluded from consideration of revenue neutral tariff filings designed to meet the long-term public interest needs in Kentucky. In order to meet the needs of the competitive marketplace, the Company will be allowed to file tariffs or options including flexible tariffs for existing or new discretionary services.²⁴

Generally, revenue neutral tariff filings involve the repricing or restructuring of an existing tariff, with any resulting revenue change applied to another tariff. For example,

²³ July 13, 1988 Motion of SCB to Conclude This Docket and to Adopt Revised Incentive Plan, page 6, and Brief of SCB, pages 24 and 25.

²⁴ Motion of SCB, pages 2 and 3.

SCB might propose to reprice its intraLATA private line services tariff, with any resulting revenue change netted against its basic local exchange service tariff.

Also, flexible tariff filings may involve some degree of marketing latitude. For example, SCB might propose to price a set of services in a price range, without seeking approval from the Commission for a specific price quotation.

While objections to these aspects of the Incentive Plan have been voiced, these conditions do not involve any new precedent. Revenue neutral and flexible tariff filings are permitted under the Commission's rules and regulations, and such tariff filings have been made in the past. Therefore, the Commission will accept this provision of the Incentive Plan.

Service Standard Monitoring

One of the concerns which the Commission must consider in addressing SCB's Incentive Plan is the possibility that the utility may have an incentive to reduce the quality of its telephone service in order to reduce costs and thereby increase potential profits. SCB, in filing its Plan and in testimony at the public hearing in this matter, stated that service quality would not decline. However, the Commission is of the opinion that continued diligence by both the utility and the Commission will be absolutely necessary in order to assure that a high level of service quality is maintained during, and beyond, the period in which the Incentive Plan is in effect.

The Commission currently receives the following service-related information from SCB:

1) A monthly Service Objective Report is filed which tracks the utility's ability to meet the various service objectives prescribed in 807 KAR 5:061. The various service objectives are reported for each of SCB's operating districts within Kentucky.

2) Special service reports are filed by SCB at the request of the Commission and Commission Staff. These reports, when required, provide service information related to annual service inspections of SCB operations, complaint investigations, and other service-related inquiries.

The Commission will not, at this time, require additional service information from SCB. However, the Commission will monitor this area closely and expects SCB to cooperate fully with the Commission Staff in this service monitoring process to assure that the Commission's Regulations concerning service are met and that service quality is maintained at a high level.

Financial Monitoring

Implementation of the Incentive Plan will necessitate establishment of a process for monitoring SCB in greater detail than is currently done. This is necessary in order to ensure that SCB's reporting is accurate and reasonable. Mr. Dickson agreed during the hearing to submit as part of the monitoring process the following information:²⁵

²⁵ T.E., Vol. I, pages 118-120.

a) Monthly Reports in greater detail than the current KPSC No. 1.

b) Monthly budget updates including assumptions and variance reports.

c) Monthly updates describing any new operating programs, FCC decisions, or other federal decisions that would impact the company operations.

d) Monthly statements adjusted for pro forma rate-making adjustments allowed in the Commission's last general rate case, Case No. 9160.

e) Commission Staff participation in on-site monitoring. Also, since forecasted data will be used, the Commission will need to monitor budget projections as well.

During the hearing, Mr. Dickson was asked if SCB would object to the AG being involved in the evaluation of earnings at the points of test. Mr. Dickson stated that SCB would not object. The Commission therefore finds that the AG should be provided a copy of all schedules filed with the Commission by SCB in determining earnings sharing at the points of test.

Although these features of financial monitoring provide a basis to begin discussions, the Commission is of the opinion that an informal conference is necessary to fully establish a financial monitoring plan. The Commission invites all parties to this case to take an active role in this conference which will be held October 25, 1988 at 10:00 a.m. in the Commission's offices.

CONCLUSION

The Commission in this Order is adopting SCB's proposed Incentive Plan with modification. The purpose of adopting an incentive plan is to provide the telephone utility an environment that encourages both entrepreneurial behavior and operating efficiency. The Commission's role in traditional rate regulation has been to act as a surrogate for competitive markets with its attention primarily focused on immediate financial results and quality of service standards. The Commission concurs with SCB and other critics that often its capacity to act in the role of a market surrogate has been limited to reacting to the immediate financial condition of the company and its immediate impact on ratepayers. In this case, the Commission is convinced that at the very least it has the opportunity to investigate a plan for regulation which may better emulate the functions of a traditional market. The traditional market rewards the innovative firm that cuts costs and develops new products, while penalizing those firms which are unable to control costs and continue to develop new and marketable products. The Commission believes that the operation of this Plan provides incentives similar to competition with the same types of rewards and penalties.

This Plan, as modified, is accepted for a 2-year experimental period beginning October 1, 1988. At the end of this 2-year period, the Commission is of the opinion that it is necessary to reevaluate the appropriateness of incentive regulation as opposed to traditional rate base regulation and to reevaluate the specific features of SCB's current Plan. The Commission in this Order

hereby notifies SCB that a formal investigation of its Incentive Plan should begin no later than October 1, 1990, and that SCB shall file its case on that date to either continue, eliminate, or modify incentive regulation.

The Commission in adopting this Plan has focused on the reduction in rates, changes in revenue requirements, and the incentive sections of the plan. The Commission does recognize that the Plan includes elements that may not be consistent with a pure incentive plan. The Commission has accepted an automatic rate adjustment provision in the Plan, which permits SCB to partially adjust its rates to the bottom of the authorized ROC range. This adjustment provides for earnings stabilization but may not contribute to SCB's operational efficiency objectives which the Commission may wish to emphasize totally in the future. At the end of this 2-year experiment, the Commission will pay particular attention to this aspect of the Plan and determine at that time if earnings stabilization provides sufficient benefits to all parties that the symmetry of the plan should be preserved.

The Commission is further of the opinion that at the end of this experiment it will be necessary to formally investigate SCB's earnings in a general rate proceeding. In addition, the Commission does recognize that some pricing and cost issues can be reasonably addressed on an ad hoc basis during the next 2 years; however, the Commission also recognizes the intervenors' concern with emerging competitive services, equitable pricing principles, and general cost-of-service studies that can be addressed only in the context of a general rate case. Because the Commission does

want to move in the most expeditious manner at the conclusion of this rate incentive experiment, the Commission hereby notifies SCB that it should file under a general rate proceeding by no later than October 1, 1990.

FINDINGS

After examining the evidence of record and being advised the Commission is of the opinion and finds that:

1. The Motion of South Central Bell Telephone Company to Conclude this Docket and to Adopt the Revised Incentive Plan should be granted with the modifications that the ratcheting provision be denied and that there be a fourth point of test.

2. The rates and charges contained in SCB's Motion are fair, just, and reasonable and should be approved as the rates and charges that SCB should charge its customers for service on and after October 1, 1988.

3. SCB's depreciation reserve deficiency is reasonable and should be amortized beginning on October 1, 1988.

4. A decision on the rate design of potential decreases and increases, proposed by SCB as Schedules 3 and 4, should be deferred to further consideration in this proceeding.

5. The decision to require refunds and surcharges or rate reductions and rate increases should be deferred to the proceedings on Schedules 3 and 4.

6. An informal conference should be held to determine monitoring procedures to be in effect for the duration of the Incentive Plan.

7. At the end of 2 years, the Commission should investigate SCB's earnings in a general rate proceeding to be filed by SCB no later than October 1, 1990.

8. At the end of 2 years, the Commission should investigate SCB's incentive regulation in a case to be filed by SCB no later than October 1, 1990.

ORDERS

The Commission, being advised, hereby Orders that:

1. The Motion of SCB to Conclude this Docket and to Adopt Revised Incentive Plan be and it hereby is granted with the modifications that the ratcheting provision is denied and that there will be a fourth point of test.

2. The rates contained in the Motion are fair, just, and reasonable and shall be the rates that SCB shall charge for telephone service on and after October 1, 1988.

3. SCB shall begin amortization of its depreciation reserve deficiency on October 1, 1988.

4. A decision on the rate design of potential decreases and increases, proposed by SCB as Schedules 3 and 4, shall be deferred to further consideration in this proceeding.

5. The decision to require refunds and surcharges or rate reduction and rate increases be and hereby is deferred to the proceedings on Schedules 3 and 4.

6. An informal conference to determine appropriate monitoring procedures during the term of this Incentive Plan be and it hereby is scheduled for October 25, 1988 at 10:00 a.m. in the Commission's offices.

7. Within 30 days of the date of this Order, SCB shall file tariffs with the Commission setting forth the rates and charges contained in its Motion.

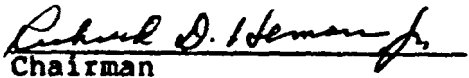
8. At the end of the 2-year experimental period of the Incentive Plan, the Commission shall investigate SCB's earning in a general rate proceeding to be filed by SCB no later than October 1, 1990.

9. At the end of the 2-year experimental plan, the Commission shall investigate SCB's incentive regulation in a case to be filed by SCB no later than October 1, 1990.

10. This is a final Order for purposes of rehearing, KRS 278.400, and appeal, KRS 278.410.

Done at Frankfort, Kentucky, this 30th day of September, 1988.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director