

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

On October 20, 1988, the Attorney General, by and through his Utility and Rate Intervention Division ("AG"), filed a Petition for Rehearing requesting that the Commission rehear five issues. The issues are: 1) the Commission's failure to require both refunds and rate adjustments at each point of test; 2) the authorized range of return; 3) not requiring certain traditional rate-making adjustments; 4) the initial rate reduction; and 5) whether the rates were fair, just, and reasonable.

On November 2, 1988, South Central Bell Telephone Company, Inc. ("SCB"), filed a response to the Petition for Rehearing. In the response SCB specifically addressed each of the issues.

Also on November 2, 1988, MCI Telecommunications Corporation ("MCI") filed a Statement in Support of the Attorney General's Petition for Rehearing.

On November 7, 1988, SCB filed a response to MCI's statement.
Refunds and Rate Adjustments

The AG has petitioned the Commission to grant rehearing on the issue of refunds and rate reductions. The AG argues that the adjustment mechanism adopted by the Commission in this case does

not reflect the operation of a competitive market and as such will not allow the Commission to achieve its regulatory objectives stated in its Order. Further, the AG contends that the Commission has misinterpreted the adjustment mechanism proposed by it in the proceedings and it should be provided the opportunity to "demonstrate not only the effect of its proposal but also the inability of the Commission adopted mechanism to account for market place realities."¹ MCI, in its response to the AG's petition, supported the AG's proposal to require both refunds and rate adjustments at each point of test.

In response to the AG's petition, SCB argues that the Commission should deny rehearing on the refunds and rate reductions issue. SCB contends that the AG's proposal would effectively take the incentive out of incentive regulation and that SCB would prefer traditional regulation to the AG's proposal.

The Commission, in reviewing the AG petition, is of the opinion that the AG has failed to provide any new evidence to support its contention that the Commission erred in its adoption of the credit refund mechanism for sharing the benefits of the incentive plan. In fact, the AG's example does demonstrate that under the operation of the plan, if the Commission adopted its adjustment mechanism, that SCB would be better off relying on traditional regulation. The Commission, in its Order, recognized that periodically both a refund and rate adjustment may be necessary; however, it continues to be of the opinion that the adjust-

¹ Petition for Rehearing of the AG, page 5.

ment of both at each point of test is inappropriate. Therefore, the Commission will deny the AG's Petition for Rehearing on this issue.

Rate of Return

The AG petitioned the Commission to grant rehearing on SCB's authorized range of return on capital ("ROC"). The AG contended that neither the cost of debt nor the cost of equity is appropriate given current market conditions. Further, the AG contends that, "there is no evidence in the record other than the evidence put forth by the Attorney General as to the proper level of return on capital."² In addition, the AG argues that, "[b]y authorizing an inflated return, the Commission has abandoned its overall policy objective of providing true incentives for efficient management of South Central Bell's telephone operations."³ Finally, MCI in its response to the AG's petition supported the AG's request for rehearing on this issue.

In responding to the AG's petition on this issue, SCB argued that the Commission did balance all aspects of SCB's rate incentive proposal including consideration of the risk to SCB and the benefits to ratepayers from the initial rate reduction and amortization of the depreciation reserve deficiency. SCB asserted that the Commission's findings are "fully supported by the record

² Petition for Rehearing of the AG, page 6.

³ Ibid.

and within the Commission's authority."⁴ Therefore SCB recommends that the Commission deny rehearing on the issue of rate of return.

The Commission, in its September 30, 1988 Order, fully considered the AG's position that the Incentive Plan should be based on an ROC range of 10.3 percent to 10.6 percent. However, the Commission felt its decision on the Incentive Plan should include a balancing of all aspects of the plan. The Commission concluded that the proposed ROC was appropriate for initiating an experimental Incentive Plan and, thus, rejected the AG's proposed ROC range of 10.3 percent to 10.6 percent. In its petition for rehearing, the AG has neither provided any new evidence nor demonstrated that the Commission erred in its original decision. Therefore, the Commission will deny the AG's request for rehearing on rate of return.

Accounting Adjustments

The AG petitioned the Commission to grant rehearing on the issue of its failure to require certain traditional accounting adjustments. In its petition, the AG stated that the Commission had ignored its own prior rulings on these adjustments without sufficient cause. The AG further argued that the Commission had stated no basis for this deviation from its prior decisions nor given any justification for the inconsistency.

Although the AG's argument was directed at all traditional accounting adjustments, the AG stated that the most troublesome

⁴ Response of SCB to Petition for Rehearing, page 5.

aspect of the Commission's ruling was the treatment of BellSouth Publishing Company ("BAPCO") revenues. The AG stated that the effect of the Commission's decision on BAPCO revenues effectively eliminated the essential contribution toward local revenues from yellow page advertising. Also, the AG argued that the decision was at odds with the Commission's stance in other proceedings and with Judge Greene's findings with respect to yellow pages advertising. United States v. American Telephone and Telegraph Company, 552 F. Supp. 131. (D.D.C. 1982).

MCI stated that it specifically supported the AG's petition for rehearing on the issue of accounting adjustments. MCI further stated that even though the Commission's Order described the Incentive Plan as an experiment, the Order permitted SCB to continue to divert substantial profits from yellow pages advertising to its sole shareholder, BellSouth, and thus, away from local ratepayers.

SCB responded to the AG's petition on this issue, stating that the AG's approach is unfair in that it ignores adjustments for known and measurable changes. Moreover, SCB stated that the AG's argument, which concludes that the Commission's Order effectively removes BAPCO earnings from the points of test, is erroneous, since actual BAPCO revenues booked by SCB will be included in the determination of earnings at each test point.

The Commission, in its Order of September 30, 1988, did fully state its reasons for not requiring the traditional accounting adjustments. The Commission has not changed its opinion. The Commission firmly believes that to require only traditional

accounting adjustments without consideration of known and measurable changes is one-sided and provides an unfair representation of earnings upon which to determine refunds or increases at the points of test. The AG's assertion that normalization-type adjustments will "take care of themselves"⁵ is not accurate. Any one event requiring adjustment does resolve itself over time. However, at any given point of test, normalization adjustments are necessary to give a true picture of future earnings.

However, if the Commission had chosen to make full and complete adjustments to earnings at each point of test, the process would result in a semiannual rate case. To choose such a procedure would have totally frustrated the Commission's intent to experiment with incentive regulation and, in fact, would have increased regulatory burden. Therefore, the Commission chose to make no adjustments to booked earnings at the points of test, but instead to review the entire process in a fully litigated rate case at the end of the 2-year experiment. At that time, the Commission can more fully evaluate the effects of these adjustments and their effect on the operation of SCB.

With regard to the issue of BAPCO revenues, a substantial level of revenue from BAPCO is booked by SCB and will be considered in SCB's earnings at each point of test. The adjustment to provide a greater level of BAPCO revenues than booked by SCB will, however, not be made at each point of test for the reasons stated above. The Commission will, at the end of the

⁵ Petition for Rehearing of the AG, page 9.

2-year experiment, review SCB's earnings in a rate case setting and make any adjustments to BAPCO revenues it considers appropriate and fair. Again, the Commission considers the adoption of this plan an experiment and not traditional rate-making. Thus, the Commission can and does make a distinction between the review of earnings at the four 6-month points of test and its review of earnings in a general rate case.

Any argument that the Commission's decision in this case is in violation of Judge Greene's decision to give the yellow page advertising to the Bell Operating Companies ("BOCs") is misleading. Judge Greene did, in fact, award the directory publishing and advertising business to the BOCs because it would provide contribution to local service. However, nothing in Judge Greene's opinion either required or prohibited a regulatory commission from making adjustments to a BOC's booked revenues from yellow page advertising. The Commission, in previous SCB cases and in past cases of other telephone operating companies, has chosen to adjust revenues above the booked amounts based on its regulatory policy concerning BAPCO. The decision of the Commission in this case to not require any adjustments (BAPCO or others) is based on its consideration of the entire incentive proposal of SCB and the requirement in the Order of September 30, 1988 that in 2 years there will be a full rate case. This decision neither violates Judge Greene's rulings nor is it a repudiation of the Commission's own decisions on BAPCO. It is a decision based on the unique conditions contained in the experimental case.

The Commission is of the opinion that the AG presented no new evidence on the issue of accounting adjustments and rehearing should be denied.

Initial Rate Reduction

The AG petitioned the Commission to rehear the issue of the initial rate reduction. The AG contended that the reduction in the September 30, 1988 Order was inadequate. The AG stated that the initial reduction of \$5.5 million was unfair, and given the Commission's failure to make appropriate accounting adjustments (described above), the approved plan guaranteed a continuation of SCB's overearnings posture. MCI supported the AG's position.

SCB, in response to the AG, emphasized that the initial reduction was \$20.4 million, which includes the 3-year amortization of the depreciation reserve deficiency. SCB went on to criticize the AG's calculation of a higher reduction, stating that the proposed calculation neglected to account for known and measurable changes to the test period.

The Order of September 30, 1988 noted that despite the arguments of the AG and other intervenors that the reduction should be greater, the Commission considered the reduction reasonable and that the reduction would not be significantly increased by extending the investigation. The AG, in its calculation of the revenue decrease, failed to consider the amortization of the depreciation reserve deficiency and its effect on earnings. The initial revenue impact is a reduction of \$20.4 million. Moreover, had the Commission pursued this investigation to allow full litigation of all elements of a general rate case,

the Commission would have made revenue and expense adjustments consistent with its policy in recognizing known and measurable changes in operating conditions.

The AG's assertion that the initial reduction is unreasonably low is unfounded, without merit, and has been addressed thoroughly in the September 30, 1988 Order.

The AG has presented no new evidence on this issue, and the Commission is of the opinion that rehearing should be denied.

Fair, Just, And Reasonable Rates

Lastly, the AG argued that the approval of SCB's incentive plan "violates the statutory provision of KRS 278.030" which states in pertinent part that:

Every utility may demand, collect and receive fair, just and reasonable rates for the services rendered or to be rendered by it to any person.

The AG argued that rehearing should be granted to allow further testimony in evidence on the incentive plan's effect, whether it meets the Commission's policy objectives, and whether it meets the statutory standard. As a summation of the prior arguments made by the AG, the AG contends that the incentive plan operates to the "lopsided advantage" of SCB vis-a-vis the rate-payers.

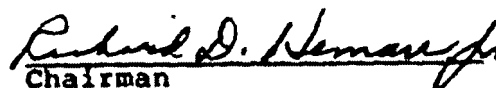
The Commission has established rates for SCB for an experimental period of 2 years in order to observe the operation of an incentive plan. The Commission has adopted rates which are neither unlawful nor unreasonable within the meaning of KRS Chapter 278.

Therefore, the Commission is of the opinion that fair, just, and reasonable rates were implemented and consequently rehearing should be denied.

IT IS THEREFORE ORDERED that the AG's petition for rehearing be and hereby is denied.

Done at Frankfort, Kentucky, this 9th day of November, 1988.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director