COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF RATES OF GTE SOUTH, INCORPORATED) CASE NO. 10117

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O R D E R

Procedural Background

On December 30, 1987, GTE South Incorporated ("GTE South") filed its letter of intent to seek additional rates and charges. On January 29, 1988, GTE South filed notice of proposed adjustments in its rates and charges pursuant to KRS 278.180 to be effective March 1, 1988. These proposed changes increased revenues in the amount of $15,577,011 on an annual basis. By Order dated February 1, 1988, the Commission suspended the proposed tariffs for 5 months on and after the effective date.

On December 30, 1987, GTE South filed a separate application with the Commission for authority to file tariff changes, to be effective as soon after January 1, 1988 as lawfully permitted, which would permit the recovery of revenue requirements caused by the change in accounting procedures adopted by the Commission in Administrative Case No. 310, Adoption of a New Uniform System of Accounts for Kentucky Telephone Companies. This application contained tariffs which would increase the existing rates for local exchange service in the amount of $5,757,507 on an annual basis effective January 19, 1988 and was docketed as Case No. 10116, Application of GTE South Incorporated for Authority to File

Tariffs for the Recovery of Revenue Requirements Caused by the Changes in Accounting Procedures. In order to investigate the reasonableness of the revised tariffs, the Commission by Order dated January 11, 1988 suspended the proposed tariffs for 5 months after the effective date.

Intervening in these proceedings were: the Attorney General of the Commonwealth of Kentucky, by and through his Utility and Rate Intervention Division ("AG"), the Lexington-Fayette Urban County Government ("LFUCG"), AT&T Communications of the South Central States, Inc. ("AT&T"), and MCI Telecommunications Corporation ("MCI"). In addition, the Commission received a number of letters and resolutions by individuals and governmental entities objecting to the proposed increase.

On January 14, 1988, the AG-LFUCG filed a motion to dismiss Case No. 10116 citing GTE South's failure to comply with the regulatory requirements of the Kentucky Revised Statutes and Administrative Regulations of the Commission. On January 20, 1988, GTE South responded stating it was seeking authority to use "special procedures" by waiving many of the administrative regulations. By Order dated January 29, 1988, the Commission granted the AG-LFUCG's motion to dismiss and denied GTE South's request for "special procedures." On February 16, 1988, GTE South filed a Motion to Set Aside the Commission's Order Dated January 29, 1988 and Grant Rehearing or in the Alternative to Consolidate Case No. 10116 and Case No. 10117. By Order dated March 8, 1988, the Commission granted GTE South's motion and incorporated Case

No. 10116 into Case No. 10117 with an identical suspension period of August 1, 1988 for the tariffs in both cases. The combined request of these proceedings is for $21,334,518.

On February 5, 1988, GTE South filed proposed tariffs, effective March 7, 1988, reflecting changes in its custom calling services. By Order dated March 4, 1988, the Commission incorporated the proposed custom calling tariff into Case No. 10117 and suspended the effective date to August 1, 1988.

On February 12, 1988, at the request of GTE South and the AG-LFUCG, counsel for the Commission and for the parties met informally to discuss the procedural schedule for the remainder of the suspension period. By Order dated March 1, 1988, the Commission entered its Order of Procedure. There were two informal conferences, one on February 19, 1988 and the other on April 12, 1988. By Order dated May 9, 1988, the Commission altered its Order of Procedure and cancelled the scheduled negotiation conference and the production of an issues list.

On May 13, 1988, GTE South filed a motion requesting that the Commission direct its Staff to identify a statement of issues which the Commission's Staff intended to challenge, as well as other issues which the Commission intended to consider in the resolution of this case. Such an issues list was sent to the parties on June 2, 1988.

On May 17, 1988, AT&T moved the Commission to consolidate a related proceeding, Case No. 10171, The Tariff Application of GTE South Incorporated (Access Services), with this general rate case. Both GTE South and AG-LFUCG filed responses on May 25, 1988. By

Order dated June 2, 1988, AT&T's motion for consolidation was denied. However, results of the Commission's Order in Case No. 10171 dated August 1, 1988 have been incorporated in this case.

GTE South sponsored prefiled testimony by the following witnesses:

Bruce M. Holmberg, Vice President
Revenue and Public Affairs

Jerry L. Austin, Treasurer

Dr. Richard W. Furst, Professor of Finance
and Dean of the College of Business
and Economics at the University of Kentucky

Alfred C. Giammarino, Controller

Bruce E. Haddad, Vice President - Finance

Quentin E. Bredewig, Director - Business Matters

Thomas C. Miller, Staffing and Compensation Director

Ronald L. Roberts, Product Planning Manager

Douglas E. Wellemeyer, Pricing and Tariffs Manager

Supplemental testimony was prefiled by Mr. Giammarino and Mr. Wellemeyer.

The AG-LFUCG sponsored prefiled testimony by the following witnesses:

Thomas C. DeWard, CPA
Senior Regulatory Analyst with
Larkin and Associates, CPAs

Dr. Carl G.K. Weaver
Economist and Principal with
M.S. Gerber and Associates, Inc.

Supplemental testimony was filed by Mr. DeWard.

A hearing was held at the Commission's offices in Frankfort, Kentucky, on June 8-10 and 13-16, 1988. Each of the above

witnesses was made available for cross-examination. Moreover, GTE South made available for cross-examination Stephen Greer, CPA, and partner in the firm of Coopers and Lybrand. Prefiled rebuttal testimony was presented by Mr. Austin, Mr. Giammarino, and Mr. Miller. Mr. DeWard presented surrebuttal testimony from the witness stand. Briefs were filed on July 11, 1988 by all parties of record.

In addition, GTE South's customers were permitted to make comments before the Commission concerning this proceeding.

On July 25, 1988, GTE South filed a motion stating that it would not exercise its statutory right to place new rates into effect subject to refund, pursuant to KRS 278.190(2), during the 30 days following the end of the suspension period provided that the Commission make the new rates effective August 1, 1988. None of the intervenors objected to the motion and by Order dated July 29, 1988, the Commission granted GTE South's motion.

In this Order, the Commission is granting GTE South an increase in intrastate revenues of $7,947,185 or approximately 5.2 percent on an annual basis.

This Order addresses the Commission's findings and determinations on issues presented and disclosed during the hearing and investigation of GTE South's revenue requirements and rate design.

ANALYSIS AND DETERMINATION

Test Period

GTE South proposed and the Commission has accepted the 12-month period ending October 31, 1987 as the test period in this case.

VALUATION

Net Investment Rate Base

GTE South reported a Kentucky intrastate net investment rate base of $333,361,807 at the end of the test period.[1] Several adjustments were made to reflect the termination of lease agreements with AT&T for interexchange facilities, the change from the subscriber plant factor ("SPF") allocator to the gross allocator of 25 percent, the changes in separations procedures for Categories 3 and 4 of central office equipment ("COE Categories 3 and 4"), the adjustment for end-of-period depreciation, and the adjustment for the effects of consolidation of the supply division of its manufacturing affiliate.

On May 10, 1988, GTE South filed exhibits that reflected a revised adjustment for COE Categories 3 and 4. At the hearing GTE South again revised its proposed net investment rate base to account for the effects of Federal Communications Commission ("FCC") Docket 86-111, as adopted in the FCC's Report and Order dated December 23, 1986 and released February 6, 1987.[2] Considering all of the above-mentioned adjustments, GTE South has proposed an intrastate net investment rate base of $335,416,046 as of October 31, 1987.[3]

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1 Giammarino Schedule 3.

2 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 Transactions Between Telephone Companies and Their Affiliates.

3 Second Revised Giammarino Schedule 3.

The Commission accepts GTE South's proposed net investment rate base with the following modifications:

Cash Working Capital

GTE South proposed to include in its rate base a cash working capital allowance of $84,198. GTE South's witness, Mr. Giammarino, testified that no lead-lag study was performed to determine the appropriate level of cash working capital and that the proposed level represented cash working fund balances.[4]

The Commission, in past cases, has disallowed a cash working capital allowance based on GTE South's advanced billing for local service. Since GTE South bills its customers in advance for local service, there is no significant "lag" between providing service and collecting payment. The Commission, in this case, finds that GTE South has provided no new evidence to support the inclusion of a cash working capital allowance and in accordance with past practice, none should be included. Therefore, GTE South's proposed cash working capital allowance is denied.

Prepayments

GTE South included in its rate base $1,480,330 for prepayments. This level was determined by applying a factor to GTE South's total company prepayments. The Commission has determined from Kentucky specific ledgers that the actual amount of intrastate prepayments is $969,320. Mr. Giammarino, during cross-examination, agreed that the actual Kentucky amount should be used

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[4] Hearing Transcript, Vol. III, dated June 10, 1988, page 11.

as opposed to an allocated amount.[5] Accordingly, the Commission has reduced GTE South's net investment rate base $511,010 to reflect the intrastate portion of Kentucky combined prepayments at October 31, 1987.

COE Categories 3 and 4

The Commission has rejected GTE South's proposed rate base adjustment for COE Categories 3 and 4 separations for reasons that will be discussed later in this Order. The Commission has determined that the appropriate decrease to telephone plant in service as a result of COE Categories 3 and 4 separations changes is $4,865,175. Moreover, the Commission has determined that an adjustment to telephone plant under construction is appropriate and has increased that account by $39,337. Concurrently, the Commission has made adjustments to the accumulated depreciation of $68,397 and to accumulated deferred taxes of $130,709.

Telephone Plant Under Construction

The AG-LFUCG proposed that the entire amount of telephone plant under construction be removed from GTE South's rate base. The AG-LFUCG stated that to allow plant under construction in the rate base without including the potential revenues to be generated from the construction would result in a mismatch because the increased return requirement is not offset by the expected revenues.[6]

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5 Ibid., page 8.

6 Ibid.

Historically, the Commission has allowed plant under construction in the rate base with an off-setting adjustment for interest during construction ("IDC") on the applicable portions. The Commission is not persuaded by the AG-LFUCG's proposal to change its policy in this case.

Other Rate Base Adjustments

Giammarino Rebuttal Schedule 2 reflected data processing equipment for the usage sensitive service ("USS") trial. Consistent with the adjustments to revenues and expenses as required in Case No. 9960, Petition of General Telephone Company of the South to Change Certain Rates and Charges for Intrastate Telephone Service, the Commission has removed $545,840 from rate base net of $225,947 of accumulated depreciation reserve and $97,118 of deferred taxes.

In addition, the Commission also reinstated customer deposits in the amount of $1,136,185.

Therefore, the Commission finds GTE South's appropriate Kentucky intrastate net investment rate base at October 31, 1987 to be $330,386,239, calculated as follows:

Telephone Plant in Service	$499,715,294
Telephone Plant Under Construction	11,888,849
Plant Held for Future Use	5,853
Subtotal	$511,609,996
LESS:	
Accumulated Depreciation	$128,311,641
Accumulated Deferred Income Taxes	55,853,400
ADD:	
Materials and Supplies	$ 1,971,964
Prepayments	969,320
Total Net Investment Rate Base	$330,386,239

Capital

GTE South reported total company capital at October 31, 1987 of $1,380,324,000, excluding Job Development Investment Taxes ("JDIC").[7] In addition, GTE South's proposed level of capitalization included capital that supported investment in nonregulated entities in the amount of $51,719,250.[8] This amount is offset by deferred taxes of $26,472,208 which results in a reduction to proposed capital of $25,247,042 for an adjusted end-of-period capital of $1,355,077,000. Using the ratio of Kentucky's net investment rate base to total company net investment rate base of .320484[9] to allocate capital, the Commission finds the Kentucky combined allocated portion of capital to be $434,280,000,[10] excluding JDIC. Kentucky's end-of-period JDIC is $24,334,000,[11] resulting in Kentucky combined capital plus JDIC of $458,614,000.

The ratio of GTE South's intrastate portion of combined net investment rate base is .714473.[12] When this ratio is applied to the Kentucky combined level of capital plus JDIC, it results in an

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[7] Staff Request No. 1 dated January 15, 1988, Item 1, Schedule 1, page 5.

[8] Notice Exhibit 5 filed January 29, 1988.

[9] $467,341,455 + $1,458,236,971 = .320484.

[10] $1,355,077,000 X .320484 = $434,280,000.

[11] Staff Request No. 1 dated January 15, 1988, Item 11, page 7.

[12] $333,986,981 + $467,459,251 = .714473

adjusted Kentucky intrastate level of capital plus JDIC of $327,668,000.

To be consistent with adjustments made to net investment, it is necessary to adjust allocated capital to reflect the appropriate level of capitalization supporting Kentucky intrastate regulated investment. Therefore, the Commission has made corresponding adjustments to capital for the adjustments made to GTE South's net investment (i.e., interexchange lease, separation of COE Categories 3 and 4, the effect of the supply consolidation, FCC 86-111, subscriber plant factor, USS, and related deferred tax changes). This produces an adjusted Kentucky intrastate level of capital of $325,153,000. The Commission finds this to be the appropriate level of capital for GTE South's Kentucky operations.

<u>Capitalization versus Rate Base</u>

GTE South's net investment exceeds allocated capital by $5,233,239. Capital cannot be assigned directly to any particular state or jurisdiction nor can it be assigned to any particular asset; therefore, an allocation is necessary. The Commission is of the opinion that capital is a more appropriate method of valuation because companies traditionally fail to exclude cost-free sources of financing in rate base. GTE South made no adjustments to reduce its net investment for cost-free components of working capital and plant, such as payables, which provide a source of cost-free financing. Therefore, the Commission believes that allocated capital is preferable to net investment because it represents the investors' actual interests.

REVENUES AND EXPENSES

GTE South reported Kentucky intrastate net operating income available for return of $29,184,699 for the test period.[13] In his testimony on behalf of GTE South, Mr. Giammarino proposed numerous adjustments which increased the level of net operating income available for return to $30,322,815.[14] This amount was later revised to $24,525,394,[15] and at the hearing, GTE South again revised its adjusted net operating income available for return to $25,030,772.[16] The AG-LFUCG, in prefiled testimony, proposed an adjusted net operating income level of $37,284,979.[17] Subsequently, the AG-LFUCG modified its proposal on several adjustments, and these changes are not reflected in the prefiled level of net operating income. The Commission has determined that the appropriate level of adjusted net operating income available for return is $30,166,758.

In its determination the Commission has considered the following issues:

Local Service Revenue

GTE South proposed to normalize its local service revenue by annualizing revenue for the last 3 months of the test year[18] and

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13 Revised Giammarino Schedule 1.

14 Giammarino Schedule 1.

15 Revised Giammarino Schedule 1.

16 Second Revised Giammarino Schedule 1.

17 DeWard Schedule 3.

18 Giammarino Prefiled Testimony, pages 4-6 and Staff Request No. 2, dated March 4, 1988, Item 19.

adding the rehearing award of $157,916 granted in Case No. 9678, An Adjustment of Rates of General Telephone of the South. This normalization results in a decrease of $11,674. In response to an information request[19] and in its testimony, GTE South stated that annualization in this manner is more representative of ongoing local service revenue because it takes into consideration fluctuations in both customer base and non-recurring charge activity.[20]

In Case No. 9678, the Commission allowed annualization of revenues in this manner, because it closely reflected a going forward level of revenues.[21] The Commission is not convinced that the going forward level is reflected in this case by such annualization.

During the test period, GTE South had two rate adjustments, one effective from April 16, 1987 until July 1, 1987, and the other effective on and after July 1, 1987. In his testimony, Mr. Giammarino stated he analyzed revenue levels only for the test period and 2 months subsequent to the test period. He did not analyze billing units or growth patterns, nor was any other study done to determine whether revenue generation was likely to continue at that level.[22]

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19 Staff Request No. 2, dated March 4, 1988, Item 19.

20 Hearing Transcript, Vol. III, dated June 10, 1988, pages 29-30.

21 Case No. 9678, Order dated April 16, 1987, page 20.

22 Hearing Transcript, Vol. VII, dated June 16, 1988, pages 67-70.

Except for the maintenance of service (trouble isolation) charge which showed end-of-period billing units only, no quantitative data was filed for non-recurring charge activity. On June 27, 1988, in response to information requested at the hearing, GTE South stated in Item 20 that non-recurring charge revenues averaged $290,000 for the last 3 months of the test period compared to an average of $206,000 during the prior 6-month period. GTE South attributed this difference to the July rate increase, fall college enrollments, Keeneland's October race season, tobacco auctions, and construction of the Toyota plant in Georgetown, Kentucky. Clearly, the non-recurring charge activity for these 3 months is not typical. However, there is insufficient data available to make a determination of the going forward level of non-recurring charge revenue. In fact, annualization of the last 3-month revenues, which includes what appear to be unusually high levels of non-recurring charge activity, may result in an overstatement of revenue. The Commission will again accept GTE South's proposed annualization in this case since this method produced an acceptable going forward level of revenues in the prior case. However, the Commission cautions GTE South that it will require detailed and quantitative support for such annualization in future cases.

The Commission will also accept GTE South's adjustments to local service revenues. These include revenue increases of $249,739 for unbilled employee concessions and $271,332 for under-collections resulting from its USS trial, and a decrease of

$729,140 to remove customer premises equipment ("CPE") revenues booked in error.[23]

The Commission has further adjusted local service revenues by $799,367 to reflect the allocation to regulated revenues for trouble determination services addressed in detail elsewhere in this Order.

With the above adjustments, GTE South's normalized local service revenue is $87,228,494.[24]

Toll Revenues

End-of-Period Adjustment

GTE South proposed to increase its test period toll revenue by $803,862 to reflect elimination of out-of-period true-ups and settlements that were included in the test period.

The AG-LFUCG proposed to increase GTE South's adjusted level of toll revenue by $3,225,558.[25] The AG-LFUCG proposed to annualize toll revenues for the 5 months following the test period. The AG-LFUCG stated that GTE South's toll revenue has

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23 Second Revised Giammarino Schedule 2.

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Test Year Actual	$86,648,870	$86,648,870
3 Months Annualized	86,479,280	
		<169,590>
Rehearing Award		157,916
Employee Concessions		249,739
USS Underbilling		271,332
Trouble Isolation		799,367
Removal of CPE		<729,140>
NORMALIZED LOCAL SERVICE REVENUE		$87,228,494

25 DeWard Rebuttal Schedule 8.

grown rapidly and will continue to do so. GTE South contended that the AG-LFUCG's adjustment violates the matching principle because the AG-LFUCG is willing to recognize the increase in toll revenues but is not willing to recognize the increased expenses.[26]

The Commission has reviewed this issue extensively and agrees with GTE South. Therefore, the Commission is not of the opinion that an adjustment to end-of-period toll is proper and the AG-LFUCG's adjustment is denied.

Unbillable Toll

The AG-LFUCG proposed an adjustment of $121,724 to amortize unbillable toll expense which was reflected on GTE South's books during the test period but which related to a prior period. GTE South disagreed with this adjustment, reasoning that even though these costs related to a prior period, they should be considered a non-recurring item and amortized over 3 years.[27]

The Commission agrees with the AG-LFUCG's adjustment. It is entirely appropriate to remove from and not recognize in the test period items which are unrelated to test period activity. It is the Commission's opinion that it is inappropriate to "reach back" and allow recovery of items properly expensed prior to the test period. This action results in an increase to net operating income of $74,513.

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26 Brief of GTE South, page 42.

27 Giammarino Rebuttal Testimony, page 99.

Interexchange Access Revenue

Tariff Adjustment

GTE South reported adjusted revenues from interexchange access service including interexchange facility leases and billing and collection of $21,093,328. GTE South's adjustment included its proposed increase in access charges in Case No. 10171 of $298,779. In Case No. 10171, based on GTE South's proposed rates and the test period in that case, interexchange access revenue, including interexchange facility leases and billing and collection, was $20,385,694. A revenue requirement of $19,993,000 for interexchange access revenue was established in Case No. 8838, An Investigation of Toll and Access Charge Pricing and Toll Settlement Agreements for Telephone Utilities Pursuant to Changes to be Effective January 1, 1984, in the Commission's Order entered November 20, 1984.

The Commission, in its Order entered August 1, 1988, in Case No. 10171, denied the proposed increase in GTE South's interexchange access charges. The Commission herein has reduced GTE South's interexchange access revenue by its proposed adjustment for the increase in Case No. 10171 of $298,779. This leaves interexchange access revenues including interexchange facility leases and billing and collection of $20,794,649. This level of revenue slightly exceeds the revenue requirement set out in Case No. 8838 and, therefore, does not shift any of the interexchange access revenue requirement to the local ratepayers. The above adjustment decreases net operating income by $182,898.

Misreported Revenue

The AG-LFUCG proposed to increase GTE South's Kentucky intrastate interexchange access revenues by $117,359 because some interexchange carriers report all business as interstate and none of the misreported revenue is assigned to intrastate operations. When interexchange carriers do not allocate between the interstate and intrastate operations, 42 percent of the revenues are assigned to interstate.[28] The Commission agrees with the AG-LFUCG's adjustment. GTE South is responsible for monitoring and collecting its interexchange revenue and the shortfall should not be charged to local ratepayers. This adjustment results in an increase to revenues of $117,359, and an increase to net operating income of $71,841.

Rent Revenues

GTE South stated that during the test period, capital carrying charge revenues associated with the use of assets by deregulated operations were recorded in rent revenues and that pursuant to FCC Docket 86-111, assets allocated to deregulated operations will be removed from the regulated books, eliminating the need for a capital carrying charge or the revenue imputed from the capital carrying charge. Therefore, GTE South proposes a decrease in rent revenues of $642,983.[29] The Commission agrees with GTE South and has reduced rent revenues by $642,983 since

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[28] AG Request No. 1, dated March 28, 1988, Item 44.

[29] Giammarino Rebuttal Testimony, page 31.

this adjustment was not reflected in GTE South's adjusted operations. This results in a reduction to net operating income of $393,602.

Uniform System of Accounts

In its Order of October 27, 1987 in Administrative Case No. 310, the Commission adopted the new Uniform System of Accounts ("USoA") prescribed by the FCC in the new Part 32 of its rules. The Commission made this change effective January 1, 1988. Under the new Part 32 of the FCC's rules, certain costs incurred by a telephone utility which would have been capitalized under the old USoA, Part 31 of the FCC's rules, would now be expensed.

GTE South proposed adjustments in this case to reflect the changes in the USoA as well as implementation costs. In GTE South's latest proposal, there are 14 major categories of capital to expense shifts. The USoA adjustments are the largest adjustments in the case and a significant portion of the record is devoted to these accounting changes. The Commission herein addresses these issues.

Budget 1988

GTE South proposed adjustments to reflect the changes from the new USoA based on its projected 1988 budget. The AG-LFUCG objected, stating that the budgeted figures were not supportable by any facts in the record.

The Commission shares the AG-LFUCG's concern about relying on the use of budgeted figures rather than historical amounts, especially in this instance. Since April 1987, the Commission has

received at least five different estimates of these budgeted amounts.[30]

Because of its concerns, the Commission asked that GTE South perform a special study of USoA changes using the calendar year 1987. This study was performed, however, it still contained the 1988 budget for all software changes. The software portion of the adjustment represents about 30 percent of the total. GTE South stated that it was impossible to restate the software accounting changes for 1987 partly because it had not received detailed invoices on computer equipment and had no data to accurately identify the different types of software.[31] The Commission is very concerned that the 1987 data for software cannot be recomputed and considers this very poor record keeping on GTE South's part. However, the Commission does herein accept the 1988 budget for software accounting changes since by April 1988 GTE South had already expensed nearly half of its proposed adjustments.

The Commission is of the opinion that the calendar year 1987 USoA changes are preferable to the 1988 budget changes because the historical amounts are less uncertain and more nearly conform to

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30 GTE South filed its original estimates in Administrative Case No. 310. Revised estimates were filed in the instant case on January 29, 1988, (Giammarino Schedule 2, page 3), February 11, 1988 (Staff Request dated January 15, 1988, Item 16), May 10, 1988 (Revised Giammarino Schedule 2, page 3), and June 9, 1988 (2nd Revised Giammarino Schedule 2, page 3).

31 Giammarino Rebuttal Testimony, pages 48-49.

test period operations in this case. Therefore, with the exception of the budget 1988 estimate of USoA changes for software, the Commission adopts the use of GTE South's 1987 calendar year study. This reduces GTE South's latest proposed Kentucky intrastate adjustment by $331,003.[32]

GTE South also reduced its proposed adjustment for changes in accounting for paid employee absences and training by $205,180.[33] This was not reflected in GTE South's latest adjustment. These adjustments increase net operating income by $328,224.

Software

GTE South has requested $1,572,813 to reflect the increased expenses resulting from the Part 32 accounting requirement to expense some types of computer software.[34] Part 31 rules were not specific with respect to whether software should be expensed or capitalized. Although industry practices leaned more heavily toward expensing, GTE South's practices leaned toward the capitalization of software.

The AG-LFUCG recommends the removal of the entire amount associated with computer software from GTE South's proposed USoA adjustment.[35] It is apparent from the record in this case that the AG-LFUCG and GTE South have fundamental disagreements regarding the interpretation of the FCC's policy concerning the

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32 $4,935,298 - $4,604,295 = $331,003.

33 Giammarino Rebuttal Schedule 6.

34 $2,162,349 x.727363 = $1,572,813.

35 DeWard Testimony, page 35.

accounting treatment of software. This policy has been succinctly stated in two separate documents, both of which have been extensively quoted in this proceeding. The first is from paragraph 132 in the Report and Order in CC Docket 78-196.[36] This paragraph states:

> 132. After considering the comments and the alternative suggestions provided, we have decided to delete the separate software account from the new system. Instead, the original cost of operating system software associated with general purpose computers will be recorded in the general purpose computers accounts, and in the case of COE software the initial right to use fee or operating system shall be classified with the central office equipment to which it predominantly relates. Barring exceptional circumstances (i.e. distortions of reported financial results) subsequent additions or modifications will be expensed to the appropriate expense accounts. (Footnote deleted.) This, we believe, strikes an acceptable balance between capitalization and expensing, which is (a) more consistent with current industry practice, (b) reduces difficulties associated with segregations of costs and identifying periods of benefit when classifying software, and (c) gives greater weight to consideration of individual circumstances. When and if the Financial Accounting Standards Board provides more definitive standards for treatment of software costs, we will consider making such changes as are necessary to conform with GAAP treatment.

The second document is Responsible Accounting Officer ("RAO") Letter 7 dated July 1, 1987. This letter contains the FCC staff's interpretation of the expense/capitalization policy for software for network operations, which states as follows:

> The capitalization policy for all software is the same whether the software is for general purpose computers classified to Account 2124, General Purpose Computers, or to other plant in service accounts dedicated to network operations: the original cost of initial operating

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[36] In the Matter of Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies Parts 31, 33, 42, and 43 of the FCC's Rules, Report and Order, Adopted May 1, 1986, Released May 15, 1986.

system software shall be classified to the same account as the associated hardware whether acquired separately or in conjunction with the associated hardware. (Section 32.2000(i)). The disposition of all other software (i.e., that which is not considered initial operating system software) shall be determined by management and shall be in conformance with generally accepted accounting principles at the time such determination is made. Currently, this could result in the expensing or capitalization of software costs, depending upon an evaluation of all relevant circumstances. With respect to subsequent additions and modifications, the Docket 78-196 Report and Order indicates, in conformance with general practice, that such costs will be expensed, barring exceptional circumstances.

GTE South's interpretation is that ". . . FCC policy recognizes three distinct groups of software, and provides for separate treatment of each of those groups:

1. The original cost of initial operating system software. -- To be classified to the same account as the associated hardware.

2. All other software not considered initial operating system software (i.e., application software). -- To be determined by management in conformance with generally accepted accounting principles based on an evaluation of relevant circumstances at the time of the determination.

3. Subsequent additions and modifications. -- To be expensed, barring exceptional circumstances."[37]

GTE South's position is that all of the software involved in the capital-to-expense shift adjustment is for subsequent additions and modifications and must, therefore, be expensed according to FCC policy.

The AG-LFUCG responded to this position by stating:

It is obvious that the Company position is incorrect, namely that all application software be expensed as the letter[38] clearly states "Currently, this could result in the expensing or the capitalization of software costs,

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[37] Giammarino Rebuttal Testimony, page 45.

[38] RAO Letter 7. Footnote added.

depending on an evaluation of all relevant circumstances." Generally accepted accounting principles requires an appropriate match between revenue and expense. It does not require expensing of software because it is not initial operating system software, nor does Part 32 state that other than operating system software, all other software, particularly application software, should be expensed as incurred. If this software is in addition to existing software, it adds features, and will last, or be expected to continue in operation over one year, there is no justification for immediately expensing this software. Again, this would be in violation of the matching principle.[39]

The Commission has reviewed these arguments and sees points of merit in both positions. This is indicative of the ambiguities in both the FCC's stated policy and its staff's interpretation of that policy. If these are interpreted from the point of view that the FCC's stated policy in the Report and Order in CC Docket 78-196 sets the only definitive standards, then it appears to the Commission that initial right to use fees and initial operating systems should be capitalized and that subsequent modifications or additions to these operating systems should be expensed, barring exceptional circumstances. Neither initial application software, nor modifications to this type of software is specifically addressed in the Report and Order. However, the FCC does state that its policy "strikes an acceptable balance between capitalization and expensing which . . . gives greater weight to consideration of individual circumstances" and emphasizes conformance to generally accepted accounting procedures.[40] This is a good indication that the treatment of initial application and

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[39] DeWard Prefiled Testimony, pages 36-37.

[40] See Footnote 36, supra.

modifications to application software is left to management's discretion, who should in turn be guided by Generally Accepted Accounting Principles. In this respect, it appears that the AG-LFUCG's arguments are correct.

If, however, the FCC staff's interpretation letter contained in RAO Letter 7, is viewed in isolation of the Report and Order, it would appear that GTE South's arguments are correct, at least to the extent of the proper accounting treatment for the various categories of software.

It occurs to the Commission that the problem is not only in interpreting the FCC's accounting requirements, but also is in deciding whether a particular program is an operating system, an application program, or a modification of one of these. The FCC's staff recognized this problem by stating:

> However, a special problem is associated with network operations computers in that many network operations computers are special purpose by design as well as by function. As a result, the distinction between the operating system and the application system is not always clearly defined. Telphony's Dictionary (First Edition: June, 1982) defines "operating system" as, "software that controls the management and execution of programs." On the other hand, an "application package" is defined as, "a computer program designed to perform a particular type of work." Such packages are usually tailored to specified needs, such as order processing, billing, inventory accounting, and data base management. Carriers should use these definitions in distinguishing between operating systems and application systems.[41]

However, the Commission is of the opinion that the FCC staff's recommended definitions are insufficient and fail to solve the problem identified -- that "many network operations computers are

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41 RAO Letter 7, page 6.

special purpose by design." "Special purpose" is normally a characteristic of application software, however, it is obviously not the FCC's intent to classify all network operations software as application software. The definitions do not provide clarification as to what should be considered an operating system and what is an application program.

An illustration of the ambiguities involved in classifying software is in the software requirements for remote switching equipment for which GTE South estimates it will expense approximately $560,000 in 1988. Mr. Giammarino testified at the hearing that a new remote unit does not require an operating system of its own, but uses the operating system of the base unit.[42] However, it appears that the software for the base unit must be modified in order for the remote switch to function. Although a strict interpretation of this situation would be to consider this software as a modification, from a purely functional viewpoint, the function of this software is to provide an operating system for the remote switch. To the extent that this software is functionally analogous to an initial operating system, it could be classified as such and, accordingly, the cost should be capitalized with the associated hardware account.

Contrary to GTE South's belief that Part 32 requires the expensing of all of the software described in its adjustment, the Commission is of the opinion that Part 32 allows for consideration of individual circumstances to conform with generally accepted

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[42] Hearing Transcript, Volume III, dated June 10, 1988, beginning page 61.

accounting principles. Moreover, the Commission is of the opinion that the classification of software required for the proper functioning of a new remote switch, by its function, should be classified as the original cost of initial operating system software and, thus, capitalized. Therefore, the Commission has disallowed that portion of GTE South's proposed adjustment which on an intrastate basis is $407,323, resulting in an increase to net operating income of $249,343. GTE South may capitalize this amount and depreciate the cost if it desires.

Hopefully, in order to promote consistency, the FCC will clarify its policy on this and other ambiguous items.

The Commission recognizes that GTE South's software purchases, relating to the establishment of remote switching equipment, may also provide for the addition of new features which would require allocating the cost of this software into capitalized and expensed components. The Commission is of the opinion that, because the remote portion of the software is nondiscretionary while the addition of new features is discretionary, these latter features should be costed on an incremental basis. While the amount of the adjustment denied above may include some portion of software for new features, the Commission is of the opinion that this amount would be minimal and, moreover, since none of the revenue from these enhanced features has been included herein, the exclusion of this software is consistent with proper matching principles. It should be noted that, at the hearing, Mr. Giammarino was asked to identify the portion of the software

expense for new features, and he stated that identification could not be done.[43]

The AG-LFUCG expressed concerns that GTE South had provided expenses for new features but had failed to provide the offsetting revenue.[44] GTE South responded to the AG-LFUCG stating that such revenues were not known and measurable and that inclusion of said revenues would be speculative.[45]

The Commission is becoming increasingly concerned about GTE South's ability to identify future expenses compared to its ability to identify revenues and savings resulting from these expenditures. Based on the evidence of record, GTE South certainly recognizes that the new software will provide additional revenues or savings. Mr. Giammarino testified at the hearing that to the extent that certain of the features relate to custom calling or enhanced features, there is the potential for revenue generation.[46] In its post-hearing responses, Item 16, GTE South substantiated this by stating:

> . . . For discretionary software enhancements such as ISDN[47] and CLASS,[48] each office is analyzed on a site specific basis for such things as demand from customer base and economic trade-offs of cost of providing the software enhancement versus economic return expected.

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43 Hearing Transcript, Vol. III, dated June 10, 1988, page 64.

44 DeWard Prefiled Testimony, page 37.

45 Giammarino Rebuttal Testimony, page 49.

46 Hearing Transcript, Vol. III, dated June 10, 1988, page 63.

47 Integrated Services Digital Network. Footnote added.

48 Customized Local Area Signalling Services. Footnote added.

Clearly, the decision to purchase discretionary software is driven by potential revenue generation.

Finally, in response to the AG-LFUCG's second information request on adjustments to the USoA capital-to-expense shift, Item 3(c)(3), GTE South provided the forecasted annual 1988 revenues for CentraNet features associated with its software adjustment to be $366,000. It also stated that "there are no 1988 revenues for advanced custom calling features due to the timing of the tariff filing."

The Commission has made no adjustment to reflect these revenues herein. However, in its next case, GTE South should provide accurate and reasonable estimates of revenues consistent with its expense estimates.

Implementation Costs

The AG-LFUCG contended that the amount of GTE South's proposed adjustment to recover the USoA implementation costs is incorrect, because GTE South has included the total company amount of costs instead of Kentucky's pro rata share.[49]

After review of this adjustment, the Commission has determined that GTE South's adjustment is correct as proposed and the expenses are the proper amounts to be allocated to Kentucky.

Regulatory Lag

GTE South proposed an adjustment of $959,586[50] to recover expenses, amortized over 3 years, from the USoA changes for the

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49 DeWard Prefiled Testimony, page 40.

50 Second Revised Giammarino Schedule 2.

months of 1988 prior to the end of the suspension period in this case. GTE South made this adjustment because its rates would not reflect the changes in USoA expense booked beginning January 1, 1988 until the Commission, in this case, reflected the change in its final Order. Thus, GTE South contends that if this adjustment is not made, it will never recover the increase in the USoA expenses for the prior period.

On December 30, 1987, GTE South filed Case No. 10116, to recover the expenses from the change in USoA in a "single issue" rate case. On January 29, 1988, the Commission in its Order in Case 10116 dismissed GTE South's case because the filing was inadequate. The Commission in an Order entered March 8, 1988 permitted GTE South to include the changes from adoption of the new USoA in this case. Subsequently, in this case, GTE South has amended its adjustment for the USoA changes three times, the latest change being made a week before the hearings.

It is obvious from the number of changes and the number of times the adjustment was changed that GTE South was not prepared to make a supportable adjustment at the beginning of 1988. Had GTE South been in a better position to make and support its adjustment for the new USoA, it might have been in a better position to file an adequate case in Case No. 10116 and might have been in a position to recover the newly booked expenses sooner.

GTE South is requesting to recover expenses booked but otherwise non-recoverable due to regulatory lag. The Commission is of the opinion that this is not proper rate-making. GTE South is continually in the process of change as are most of the

utilities under the Commission's jurisdiction. Regulation cannot capture every change either positive or negative. The test period concept allows for a period of normal operation to be used as a representative base to set rates for the future. Whether GTE South recovered the accounting changes in the months of 1988 prior to this Order or not, the Commission cannot determine as it is not possible to reach back to this period and hand pick one expense and state with assurance that this expense was not recovered.

Nor is it fair to ratepayers to allow retroactive adjustments. It is the job of a utility to file for rate relief in a timely and supportable manner to ensure that its earnings are adequate.

Thus, the Commission sees no reason to allow retroactive adjustments for this or any other expenses and, therefore, disallows GTE South's proposed adjustment resulting in an increase to net operating income of $587,411.

Separations Adjustments

By Revised Adjustment J, detailed in Revised Giammarino Schedule 9, GTE South proposed to increase intrastate investments and expenses to reflect changes in jurisdictional separations procedures. These procedures are prescribed in the new Part 36 of the FCC's rules, formerly Part 67. Revisions were necessary to conform the existing separations procedures to the new USoA. The changes in separations procedures are described in CC Docket 80-286, Report and Order, adopted April 16, 1987. In that Order, the FCC adopted the Federal-State Joint Board's recommendations for the revision of the rules regarding jurisdictional separations

procedures for COE. This Order consolidated the original eight categories of COE into four categories. In addition to consolidating these categories, the FCC changed the method of allocating the new COE Categories 3 and 4 investments between jurisdictions. These changes will be discussed separately.

COE Category 3

The new COE Category 3, Local Switching Equipment, is composed of the former COE Categories 4, 5, 6, and 7. Under Part 67, these investments were allocated on the basis of usage weighted by distance factors, or weighted dial equipment minutes ("DEM").[51] The new method eliminates distance as a factor and is now simply referred to as the DEM allocator. The removal of distance as a factor has the effect of allocating more of the investment to the jurisdiction which averages shorter distance calls, i.e., to the intrastate jurisdiction. To modify the effect of this change, the FCC has required this change to be phased-in over a 5-year period, beginning in 1988. For 1988, the new allocator is the sum of two components -- 90 percent of the weighted DEM allocator plus 10 percent of the unweighted allocator.

GTE South proposed to increase the intrastate portion of the rate base by $3,062,089 and depreciation expense by $133,312. In addition, it proposed to increase intrastate operating expenses by $380,813 to reflect the higher intrastate investment.

51 Which is defined by the FCC as being the minutes of holding time of the originating and terminating local switching equipment.

The AG-LFUCG did not propose a quantified adjustment. However, on page 4 of Mr. DeWard's Supplemental Testimony, he expressed his concern over this adjustment by stating:

> It is my opinion that the Company should be required to (1) state whether any shift in costs in other categories of central office equipment are required by the adoption of Part 36 and, if so, provide details of the revenue impacts; (2) state how the Company reflected these (category 3 and 4 and other) shifts in its FCC filing which established interstate rates for 1988; (3) state the revenue impact of these shifts on its intrastate access revenues. In other words, if these costs are shifted to intrastate, by how much, if any, would the Company recover through its intrastate access revenues.

Although the Commission does agree that the change in separations procedures will increase some intrastate investments and expenses, the Commission disagrees with some of GTE South's calculations for the following reasons:

1. The rate base used in the case is an end-of-period level; therefore, any changes in intrastate investment should be based on the change to this level of investment. GTE South's calculation is based on projected 1988 investment levels and, therefore, does not only recognize the increased intrastate separations factor resulting from the use of Part 36 rules, but also includes the projected growth in COE Category 3 investments as well. In its calculation, GTE South provided a projected December 31, 1987 investment level. The Commission considers this level of investment to be more representative of test period levels.

2. Along with the use of a projected 1988 investment level, GTE South also developed a projected Part 67 factor. Again, the Commission considers the Part 67 factor used to separate the

projected December 31, 1987 investments to be more representative of the Part 67 factor used to separate end-of-period investments.

3. GTE South projects increased expenses as a result of the separations change despite the fact that most categories of expenses were unaffected by the change to Part 36. It is important to recognize that the purpose of the entire separations adjustment is to reflect the shift of investment from the interstate jurisdiction to the intrastate jurisdiction. This also applies to corresponding shifts in expenses. The only expenses that would reasonably change would be those that are separated into intrastate and interstate components based upon relative investment levels. Obviously, the separations of depreciation expense and maintenance expense are highly dependent upon the separations of investments and are, therefore, properly included in the expense adjustment. The relationship between COE Category 3 investments to general administrative expenses, such as allowances for uncollectible revenues and social security taxes, is less clear. At the hearing, Mr. Wellemeyer was asked to identify any administrative expenses that are allocated on the same basis as plant accounts and was unable to do so.[52] Therefore, the Commission will only allow expense adjustments for maintenance and depreciation expense, and property taxes resulting in a reduction to operating expenses of $397,272 increasing net operating income by $243,190. GTE South has failed to show that

[52] Hearing Transcript, Vol. V, dated June 14, 1988, page 7.

any other expenses will increase as a result of the separations changes.

Finally, in response to requests for information agreed to by the witnesses at the hearing, most of which was filed on June 27, 1988, GTE South agreed that it would be appropriate to reflect changes to rate base on a net book basis in order to reflect associated accumulated depreciation, deferred taxes, and short term telephone plant under construction. It did not agree that adjustments on a net book basis would be appropriate in the calculation of annual expenses because the annual expense factors were developed to be used with gross investments. The Commission concurs with these adjustments.

To summarize these adjustments:

Projected 12/31/87 Investment	$156,970,032
Composite Part 36 Factor	x 0.21595281
Interstate Investment-Part 36	$ 33,898,120
Interstate Investment-Part 67	$ 35,124,279
Change to Interstate Investment	($ 1,226,159)
Change to Intrastate Investment	$ 1,226,159
Weighted Annual Expense Factor	x 0.0583
Increased Intrastate Expense	$ 71,485
Change to Intrastate Investment	$ 1,226,159
Depreciation Expense Factor	x 0.0370
Increased Depreciation Expense	$ 45,368
Change to Intrastate Investment	$ 1,226,159
Net Book Ratio	x .719335[53]
Increase to Intrastate Net Book	$ 882,019

53 $129,332,446/($171,891,824 + $7,902,622)

COE Category 4

The new COE Category 4, Circuit Equipment, is the former COE Category 8. The Part 36 separations change in this area affected only a sub-category of circuit equipment, Category 4.23, All Other Interexchange Circuit Equipment. Although the title of this category implies that it contains miscellaneous equipment and is, therefore, insignificant, this category actually contains the majority of the investment in circuit equipment. As with Category 3, one of the changes in the method used to separate interstate investments from intrastate investments is the elimination of distance sensitivity from the calculation. In addition, the new procedures require the use of termination counts rather than circuit counts or circuit termination counts. Although this sounds like a rather esoteric and complicated distinction, it simply refers to the fact that an entire circuit may be composed of several intermediate circuits connected together. The Part 67 method counted only the extreme end points of circuit. The new part 36 method, effective January 1, 1988, counted these intermediate points as well as the end points.

Based on this new Part 36 method, GTE South proposed to increase the intrastate portion of the rate base by $2,673,098 and depreciation expense by $102,299. In addition, it proposed to increase intrastate operating expenses by $283,964 to reflect the higher intrastate investment. These adjustments were subject to change, as GTE South noted:

> The procedures for allocating Category 4 according to the New Part 36 are under further investigation by the FCC. Therefore, the amount of this adjustment could change based on the outcome of that investigation.[54]

As anticipated, on June 27, 1988, the FCC adopted for release on August 8, 1988 its Order on Reconsideration in CC Docket Nos. 78-72, 80-286 and 86-297.[55] Regarding COE Category 4, the FCC "...conclude[d] that to best achieve the goals and intended results in this proceeding, LECs should not count intermediate terminations in assigning the costs of Category 4.23 COE."[56] Therefore, the Commission's adjustments reflect Part 36 as amended in the Order on Reconsideration, along with adjustments similar to those outlined in the Category 3 adjustment. GTE South did not provide 1987 investment levels nor the appropriate Part 67 factor for 1987 which made it impossible to make the adjustments for the test period in this case. However, the Commission believes that since both the factor and the investment are based on separations studies for the same 1988 time period, the results may be more consistent, and it has therefore used the 1988 data. To summarize these adjustments:

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54 Giammarino Schedule 9.

55 CC Docket Nos. 78-72, 80-286, 86-297, In the Matter of MTS and WATS Market Structure; Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board.

56 Ibid., Order on Reconsideration, paragraph 14.

Change to Intrastate Investment	$	(316,810)
Weighted Annual Expense Factor	x	0.03363
Increased Intrastate Expense	$	(10,654)
Change to Intrastate Investment	$	(316,810)
Depreciation Expense Factor	x	0.03827
Increased Depreciation Expense	$	(12,124)
Change to Intrastate Investment	$	(316,810)
Net Book Ratio	x	.542206[57]
Increase to Intrastate Net Book	$	(171,776)

The aforementioned adjustments result in an increase to net operating income of $250,395.

GTE South's Post-Consolidation Study

GTE South submitted several cost-benefit studies in this case. These studies were the result of the Commission's Order in Case No. 9678. In that Order the Commission stated, ". . . that absent an analysis of the benefit to Kentucky ratepayers no future increases in the Durham headquarters will be considered beyond this level."[58] In this case GTE South has filed a post-consolidation study that purports to demonstrate that Kentucky ratepayers did derive benefits from the 1984 merger. The study was prepared and conducted by Coopers and Lybrand and was sponsored in this proceeding by Mr. Haddad. In addition, GTE South provided Mr. Greer, senior partner of Coopers & Lybrand, to respond.

In response to the study, the AG-LFUCG contended that it is of limited value because, "There exists a significant barrier to

57 $53,193,812/($93,598,608 + $4,507,704)

58 Case No. 9678, Order dated April 16, 1987, page 24.

translating the Coopers & Lybrand net benefit conclusion into any measurable current benefit."[59] The AG-LFUCG goes on to argue that, ". . . Mr. Haddad uses [the study] to justify the skyrocketing home office allocation" when ". . . there was no empirical evidence of savings."[60]

The Commission in reviewing this study recognizes its many limitations. The Commission agrees with both the AG-LFUCG and GTE South that the study has limited value in assessing the cost/benefit of the merger in today's telephone environment and certainly provides little support for the General Office allocations. However, the Commission is of the opinion when consolidation did occur in 1985 that GTE South has demonstrated that there were some benefits to Kentucky ratepayers. The allocation methodology in use in 1985 estimated the net benefits at $5.5 million for Kentucky ratepayers while the FCC/NARUC methodology resulted in $900,000 in net benefits.[61] The Commission in its Order in Case No. 9678 did not intend to continue to revisit the original merger decision in all future cases as justification for the Kentucky General Office allocation. The Commission does intend to place GTE South on notice that in all future reorganizations it will require cost-benefit studies to demonstrate benefits to Kentucky ratepayers from the reorganization. These studies should be conducted prior to GTE South's decision to implement

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59 AG's Brief, page 20.

60 Ibid.

61 Haddad Prefiled Testimony, pages 13 and 14.

consolidation and the results filed with the Commission at the same time as GTE South's request for Commission approval of the consolidation or reorganization.

General Office Expenses

General Office Expense Allocation and Value of Service Study

One of the major issues carried forward to this case from GTE South's last general rate case is the level of General Office expenses allocated to the Kentucky operations. General Telephone of Kentucky officially merged with General Telephone of the Southeast on December 31, 1985 although the centralization of operations had been taking place since the early 1980s. Durham, North Carolina, the General Office headquarters of the southeast operations, continued as headquarters for the newly merged entity, but it was not until the beginning of 1987 that a common expense allocation procedure, employing the jurisdictional allocation procedures Part 36 (formerly Part 67) of the FCC's rules, was implemented for all 8 states. As a result of the implementation of the common procedure, General Office expenses allocated (this does not include amounts directly charged) to Kentucky operations rose significantly, as evidenced by the following levels: $7.4 million in 1984, $10.8 million in 1985, $10.8 million in 1986, and $19.7 million for the test period, the 12-months ending October 31, 1987.

The AG-LFUCG objected to the use of Part 36 as the allocation method proper to assign allocable costs from the General Office to the eight states.

Because of the rapid escalation in the General Office expenses, the Commission in its Order in the last rate case entered April 16, 1987 emphasized that absent a complete analysis proving that the expenses of the General Office headquarters are proper, necessary, and a benefit to Kentucky ratepayers, no further allowance would be recognized. GTE South provided its analysis in this case. Portions of a General Office Value of Service study were submitted with the testimony of Mr. Haddad.

The General Office provides centralized administrative support for the company. This support includes administrative operations functions such as accounting, human resources, network engineering and information management, and administrative planning functions, such as strategic planning, network planning and budgeting. The objective of the General Office Value of Service Study was to substantiate the benefits of the General Office administrative staff to the ratepayers of Kentucky.

All of the services performed by the General Office in Durham were identified, the need for each service in Kentucky was determined, and alternative means for obtaining the service as well as the cost of doing without the service were quantified to the extent possible.

The Commission is concerned with certain aspects of the Value of Service Study. GTE South's witness, Mr. Greer stated, ". . . [Coopers & Lybrand] worked with GTE of the South personnel [but] they did much of the work."[62] In another response, Mr. Greer

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[62] Hearing Transcript, Vol. III, dated June 10, 1988, page 105.

indicated ". . . that there was a potential for bias, in all honesty, in both directions."[63] This raises the issue of whether employee objectivity is compromised in trying to justify their jobs.

The Commission also wants to make note of the fact that submission of only parts of the study prior to the hearing posed review problems for the Commission Staff and the intervenors.

The Commission also questions the reliability of the estimates for contracting for activities outside of GTE South. Responses to questions on this topic during the hearing indicated an imprecise method for identifying activities to be contracted out and for estimating their cost.[64]

By conducting the study GTE South has complied with the Commission's direction in Case No. 9678. The Value of Service Study examined a number of functions of the General Office and evaluated different methods of accomplishing these tasks. Despite the Commission's concerns, the study methodology did include mechanisms to attempt to achieve objectivity. For example, the hiring of an outside firm to oversee the study rather than preparing the study in-house indicates a degree of objectivity. In addition, the information provided to the employees in their preparation of the study at least partially offsets potential biases. Finally, the study, as presented, did show positive

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63 Ibid., page 105.

64 Ibid., page 178.

benefits and a need for the service. Therefore, the Commission will make no adjustment to disallow a portion of the expense.

General Office Expenses Normalized

GTE South reported General Office expenses allocated to Kentucky during the test period of $19,655,787. GTE South proposed an adjustment of $1,772,022 ($1,336,879 on an intrastate basis) to reflect the increase in the allocation methods for the months of November and December 1986, booked prior to the change to allocation procedures in Part 32 of the FCC's rules.

The AG-LFUCG objected to this adjustment because it was not adequately supported and because other months of the test year, subsequent to adoption of allocation procedures under Part 32 of the FCC rules, contained abnormalities.

In response to the AG-LFUCG, GTE South, recognizing the nonrecurring cost of implementing the USoA and the abnormalities of a "standing one-month accrual" in January through April, chose to use the period of June through October 1987 on which to make its adjustment, as that period was, in GTE South's opinion, more representative of the going forward level.[65] This resulted in a pro forma level of $20,849,280, an increase of $1,193,493 ($877,129 on an intrastate basis). Further adjustments by GTE South were made which resulted in a pro forma level of $20,944,441, an additional increase of $95,161 ($68,904 on an intrastate basis).[66]

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[65] Giammarino Supplemental Testimony, page 12.

[66] Giammarino Rebuttal Testimony, Schedule 7.

The AG-LFUCG's witness, Mr. DeWard, in his rebuttal testimony, proposed to reduce General Office expense an additional $2,299,641 ($1,690,065 on an intrastate basis) for a going forward level of $18,644,800 to further recognize the abnormalities of January through April. There is little doubt that amounts during the first 5 months of 1987 ($10,176,645) and the second 5 months of 1987 ($7,679,863) are substantially different. GTE South even recognized the abnormalities of the first 5 months.[67] Thus, after much consideration, the Commission rejects GTE South's adjustments and accepts the AG-LFUCG's adjustment of $1,690,065. This results in an increase to net operating income of $1,034,573.

General Office Capital Carrying Charges

The General Office capital carrying charge is the charge by which Kentucky and the remaining six states of GTE South repay North Carolina for the Durham headquarters common investment recorded on the books of North Carolina. The capital carrying charge is developed in a study called the Annual Carrying Charge Study. This study takes several months to prepare and includes a return on investment, amortization, depreciation, taxes, and maintenance expense for the Durham headquarters common investment. The lag between development of a capital carrying charge and billing is approximately 2 years. Because this lag exists, the test period included a capital carrying charge incorporating very old information. Federal income taxes, for example, were included

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67 Ibid., page 62.

in the test period level of General Office capital carrying charges at 46 percent instead of the current 34 percent rate.

The return on equity included in the test period General Office capital carrying charges was North Carolina's last authorized return on equity of 15.5 percent as opposed to the return on equity found reasonable in Kentucky's last general rate case of 12.25 percent set out in the Order of April 27, 1987. The Commission believes that Kentucky ratepayers should pay the Kentucky approved return on equity on the common investment in North Carolina.

In response to a Commission Staff data request, GTE South provided a calculation of an adjustment of $419,012, which reflected the current costs and the Kentucky approved return on equity in the test period General Office carrying charges.[68] The Commission is of the opinion this adjustment is necessary and has adopted GTE South's calculation resulting in an increase to net operating income of $256,498.

In his rebuttal testimony in this case, GTE South's witness, Mr. Giammarino, stated that if the Commission chose to make the above adjustment to the North Carolina capital carrying charges, the adjustment would have to be made to reflect adjustments for capital carrying charges from other states made to share the costs of common investment in Lexington, Kentucky, and recorded on the Kentucky books.[69] Apparently, a similar lag in development and

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68 Staff Request No. 3, dated April 5, 1988, Item 5b.

69 Giammarino Rebuttal Testimony, page 65.

billing may exist in the capital carrying charge on Kentucky investment. The Commission agrees with Mr. Giammarino, but as GTE South did not provide the appropriate adjustment or supporting information, no adjustment is included herein.

General Office Employee Pension Costs

The AG-LFUCG proposed an adjustment to operating expenses of $364,818 to reflect an expected reduction in employee pension costs included in General Office expenses.[70] The AG-LFUCG made this adjustment because GTE South had made adjustment to its Kentucky employee pension expenses to reflect a new actuarial study and the AG-LFUCG reasoned that a comparable adjustment should be reflected for employee pensions included in the General Office expenses. The AG-LFUCG made its adjustment proportionate to the Kentucky reduction.[71]

GTE South responded that, overall, the pension expenses allocated to Kentucky and included in the test period were understated since the actuarial study showed that the remaining seven states' pension expenses were increasing and that General Office expenses should be increased rather than decreased.[72] The Commission agrees with GTE South and has not accepted the AG-LFUCG's adjustment.

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70 DeWard Schedule 29.

71 DeWard Testimony, page 62.

72 Giammarino Rebuttal Testimony, page 86.

Affiliated Company Transactions

GTE South is one of seven domestic telephone operating companies owned by General Telephone and Electronics, Inc. ("GTE"). These operating companies along with its international telephone operations and its Business Services Organization comprise the largest part of GTE's business. The Business Services organization is comprised of GTE Mobilnet, GTE Directories, GTE Data Services and GTE Telcom, consisting of its Communications Management Division, GTE Airfone and GTE TeleMessenger. Comprising its communication products affiliates are GTE Communication Systems, including its GTE Supply Division, GTE Government Systems and GTE Consumer Communication Products. GTE's research arm is GTE Laboratories. The above companies along with GTE Service Corporation comprise the principal telephone and related operations of GTE.[73] All entities discussed are wholly owned by GTE.

GTE Directories publishes telephone directories for both affiliated and non-affiliated telephone companies domestically and abroad. The majority of revenues are derived from the sale of yellow page advertisements. It pays all expenses related to the publishing of the telephone directories, but through its standard

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73 In July 1988 the "Management and Operations Study of GTE South," performed pursuant to KRS 278.255, was released. It enumerates several recommendations for GTE Data Services, GTE Laboratories, and GTE Supply Division. The Commission is interested in any studies performed as a result of the recommendations contained in the Audit Report and anticipates it will consider them in the next rate case.

contract, GTE Directories receives a publishing fee at a fixed percentage of gross yellow page revenues. GTE Directories' return on common equity for 1987 and 1986 was 29.9 percent and 27.9 percent, respectively.[74]

GTE Data Services provides data processing and information management services to its affiliates and sells computer-based services competitively outside the GTE infrastructure and also provides information services to the cellular telephone industry. Data Services is in the process of consolidating its data processing centers from 11 to 6 to promote quality, cut costs and strengthen its position. In 1987, Data Services' revenues grew 15.6 percent following a 22.5 percent increase in 1986 and the return on common equity was 25.4 percent for 1987 and 26.5 percent for 1986.[75] Although the level of non-affiliated transactions continues to grow, they still represent a very small portion of total operations.

GTE Communications Systems develops, manufactures, and markets communications equipment for its affiliated operating companies, non-affiliates, and military and government agencies. It also markets residential and small business products.

GTE Laboratories ("GTE Labs") provides research and development of new products for GTE Corporation. Services are provided to both regulated and non-regulated functions of the

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74 DeWard Prefiled Testimony, Schedule 14, and Revised Schedule 14.

75 Hearing Request, Item 49, pages 11 and 13.

telephone operating companies along with services to non-affiliated and government agencies.

GTE Service Corporation provides corporate support for all affiliated companies of GTE Corporation.

The amount of allocated and direct costs to Kentucky combined operations for the above described affiliates during the test period were as follows:

GTE Directories	$ 6,991,426
GTE Data Services	9,433,584
GTE Communications Systems	7,036,134
GTE Service Corporation and GTE Laboratories	4,417,941
TOTAL	$27,879,085

Total combined operating expenses and taxes for Kentucky operations for the test period were $176,689,013.

It is apparent from the above illustration that allocated and directly charged costs from affiliates to the Kentucky operations comprise a significant portion of the cost of service of Kentucky ratepayers. Therefore, to insure that the rates being collected by GTE South are just and reasonable, it is mandatory that the Commission investigate the reasonableness of these costs.

<u>Directory Revenues</u>

For the test period, GTE South reported $13,499,106 in gross directory advertising revenues from its publishing affiliate, GTE Directories. From this amount GTE South paid GTE Directories $6,991,426 in publishing fees for net directory advertising revenues of $6,507,680.

Under the contract executed in 1975, GTE Directories pays substantially all expenses involved in selling the advertising, compiling directory material received from the telephone company, maintaining GTE South's data base of customer listings, printing and copyrighting all directories, and shipping the directories to the local telephone exchanges. GTE Directories also incurs the costs of preparing advertising copy, supplying cuts and advertisements, rewriting and revising all advertising copy whenever necessary, compiling classified listings, printing such advertising copy, and promoting the use and value of yellow page advertising. GTE South furnishes the subscriber listings for inclusion in the directories, distributes the directories to its customers, and bills and collects the advertising revenues. GTE South's Kentucky operations retain 51.1 percent of the monthly directory advertising billing, less a comparable share of uncollectibles. The balance goes to GTE Directories as its share of the billed revenues.

As in last year's case, directory advertising revenue is one of the more contentious issues in this case. The AG-LFUCG imputed an increase in revenues to the Kentucky operation to reduce the return realized at GTE Directories to a level commensurate with its recommended return. In support of its adjustment, the AG-LFUCG described how the California Public Utilities Commission, in its recent GTE operating company case, imputed a similar adjustment based on authorized return. As described by the AG-LFUCG, the adjustment in California is long-standing and General

Telephone Company of California actually incorporates a directory revenue adjustment in its filing.

The Commission continues to believe an adjustment to GTE South's directory revenue is necessary. The retention ratio of 51.1 percent has not been renegotiated since 1975, 13 years. GTE South's witness on directory revenues, Mr. Roberts, when asked why GTE South had not made any attempt to renegotiate the contract during this time, stated it was not done because, "we have not found that that was necessary or appropriate,"[76] and later that,

> We have not seen issues in the marketplace and we have not seen performance from that particular agreement that would lead us to think that we could do better.[77]

The Commission finds it inconceivable that no differences could be found in the marketplace during the tenure of the current contract. Not only has the Kentucky operations changed dramatically (i.e., growth and merger), the entire telecommunications industry has changed dramatically both from a technological and competitive point of view. Mr. Roberts, moreover, could not say whether any other source of directory publishing had been considered with regard to renegotiation of the contract and was only generally aware that GTE South does business with non-GTE companies.[78]

Mr. Roberts also stated that GTE South would have every right to reopen the contract at any point and determine whether it

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[76] Hearing Transcript, Vol. V, dated June 14, 1988, page 120.

[77] Ibid., page 126.

[78] Hearing Transcript, Vol. V, dated June 14, 1988, page 140.

wanted to renew for a subsequent year. However, he could not point to any studies or comparisons undertaken by GTE South to determine whether the contract was indeed the most profitable GTE South could have at this time.[79]

GTE South contended that GTE Directories Corporation and the provision of directory publication is a non-regulated aspect of the provision of telecommunication service. However, Mr. Roberts agreed it was true that a customer of GTE South, as part of basic telephone service, expects to have a directory from GTE South. Thus, Mr. Roberts conceded that the provision of a directory from GTE South is related to basic telephone service. Moreover, GTE South witness, Mr. Holmberg, in his testimony, stated that directories publication should provide a contribution to the local service, and that in his opinion state regulatory commissions who made no adjustments to directories did so because they believed that directories provided the appropriate amount of contribution.[80]

Therefore, the Commission is of the opinion that the provision of directories is related to basic local service and that GTE South has not taken the necessary steps to ascertain whether the contract it has with the affiliate, GTE Directories, is indeed providing a reasonable revenue level. Mr. Roberts described the contract as arms-length. However, he stated he had not attempted to renegotiate the contract, he had not reviewed

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[79] Ibid.

[80] Hearing Transcript, Vol. I, dated June 8, 1988, page 114.

contracts between GTE Directories and non-affiliated companies, he had not compared the retention ratio of GTE South with those of other jurisdictions or other affiliated telephone operating companies, and he was not aware whether any other GTE telephone operating company had directory publishing services provided by any company other than GTE Directories.[81] The Commission is of the opinion that GTE South has not adequately determined that the contract between GTE South and GTE Directories is providing GTE South a reasonable level of revenues.

In those areas having large metropolitan populations served by GTE telephone operating companies, specifically in California and Florida, the retention ratios are 58.5 percent and 58 percent, respectively. It is the Commission's opinion that had GTE South taken an active role in obtaining the best possible contract with GTE Directories it should have been able to achieve a retention ratio of at least 58 percent similar to these states.

In its testimony, the AG-LFUCG imputed an increase in revenues to the Kentucky operation to reduce the return realized by GTE Directories to a level commensurate with its recommended return in this case. In its adjustment, the AG-LFUCG obtained Kentucky specific information from the general ledgers and other information from GTE Directories' financial statements for 1987. Using this information, Mr. DeWard found that Kentucky should have received an additional $1,166,391 of directory advertising revenues assuming it earned only the AG-LFUCG's recommended return.

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81 Hearing Transcript, Vol. V, dated June 14, 1988, page 152.

As stated in Case No. 9678, GTE South provided the Commission with a calculation of the adjustment, but when asked to provide a similar adjustment in this case, GTE South responded as follows:

> GTE South is unaware of any recognized or authoritative allocation technique or procedure by which revenues of GTE Directories corporation can be appropriately allocated to GTE South's Kentucky operations. On this basis GTE South declines to make an allocation which, by definition, would be arbitrary and which it could not support.
>
> GTE South disagrees that revenues of GTE Directories Corporation should be allocated to its Kentucky operations on the basis of the authorized rate of return of GTE South or on any other basis.[82]

The Commission believes strongly that GTE South should have provided the calculation as requested. Many jurisdictions make an adjustment with respect to directory revenues and, as noted, GTE of California includes an adjustment in its filing.

As stated in the final Order and the Order on Rehearing in Case No. 9678, the Commission is of the opinion that a reasonable level of profit derived from the affiliated transaction between GTE South and GTE Directories should be returned to the local company for the purposes of establishing rates. Through a contractual relationship with an affiliate which receives such minimal review by GTE South, as described above, GTE South may not shield revenues from the determination of the regulated ratepayers' rates.

In its brief, at pages 47-49, GTE South described several problems it has with the AG-LFUCG's calculation for the adjustment

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[82] Staff Request No. 1, dated January 15, 1988, Item 42d.

for directory revenues. GTE South objects to the exclusion of publication advertisement printing revenues from expenses and the use of the proposed common equity return.

The Commission has recalculated the AG-LFUCG's adjustment to reflect GTE South's concerns with the exception of its opposition to the proposed return. It also finds that the calculation as presented needs to be modified to reflect normal operating expenses, the weighted cost of debt, interest synchronization, and current Kentucky and federal income tax rates. Based on the above modifications, the Commission has determined that directory revenues could be increased $1,381,022 based on the return found reasonable herein. This results in an adjusted directory revenue of $7,888,702 or a retention ratio of 58.44 percent.

The Commission has adjusted directory revenue by $1,321,801, based on a retention ratio of 58 percent. This thereby increases net operating income by $809,140.

The Commission strongly encourages GTE South to renegotiate its contract for directories and conduct such negotiations with GTE Directories as though it were not an affiliate. Such review of the contract should include a comparison of other retention ratios for affiliated companies as well as contracts which GTE Directories has with non-affiliated companies. After contract renegotiation, GTE South may be in a position to earn as much or more directory revenue than adjusted herein. The results of these negotiations should be included in GTE South's next general rate proceeding.

GTE Service Corporation Value of Service Study

In its Order in Case No. 9678, the Commission directed GTE South to obtain detailed billing from GTE Service Corporation and to continue to perform a cost/benefit analysis on an annual basis. The Commission is aware that billing detail at a functional level is now being received, and continues to emphasize that its intent was to have GTE South determine the reasonableness of such billings. As instructed, GTE South included a Value of Service Study for GTE Service Corporation.

The Service Corporation Value of Service Study methodology involved the identification by GTE South management of all services performed by the Service Corporation for GTE South's regulated operations and then quantifying two alternative means of obtaining this service, as well as the cost of doing without the service. The two alternatives were: (1) to perform the functions within GTE South; and (2) to contract with an outside vendor to perform the services.

The Commission is concerned with the estimates for performing the activity externally. GTE South's witness, Mr. Haddad stated ". . . generally, it was left up to the judgment of the individual preparer."[83] Given the diversity of people who prepared these estimates, it is difficult to believe there was a uniform method used in making these assessments. The Commission has a similar concern about the development of the costs of foregoing services. As Mr. Haddad stated, "Again, this was for the most part, left to

[83] Hearing Transcript, Vol. IV, dated June 13, 1988, page 33.

the--or generally was left to the judgment of the individual involved."[84]

The Commission in requiring a Value of Service study for the GTE Service Corporation's services provided to GTE South fully realizes the magnitude of the effort. GTE South has made progress in its evaluation of these services and the Commission commends it for its progress. The Commission does anticipate greater use of billing detail in the future and a more uniform approach to its value and cost estimates. The Commission is of the opinion that GTE South has demonstrated sufficient benefits from the GTE Service Corporation contract to justify the expenses associated with it. Therefore, it will make no adjustment to test period charges. However, the Commission does intend to continue to scrutinize the contract and will require a Value of Service study for the GTE Service Corporation contract in future rate proceedings.

GTE Laboratories

The AG-LFUCG proposed an adjustment for what it considers to be excessive costs paid to GTE Labs by GTE South. The AG-LFUCG uses as a basis for the adjustment certain information developed by the California Public Utilities Commission in its investigation of General Telephone Company of California. The AG-LFUCG concluded that GTE South was overbilled $232,875 on a Kentucky intrastate basis during the test period. The AG-LFUCG further stated

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84 Ibid., page 34.

that should the use of the California data be rejected by the Commission, in the absence of a showing of direct benefits to Kentucky, all GTE Labs' expense should be disallowed.

The Commission has not investigated the California study nor has it had the opportunity to conduct its own investigation. Therefore, the Commission rejects the AG-LFUCG's proposed adjustment. However, the Commission puts GTE South on notice that in future proceedings a full description of GTE Labs' charges billed to Kentucky will be required. GTE South will be required to prove that GTE Labs' services provided benefits to Kentucky ratepayers and that the benefits exceed costs.

GTE Data Services

The AG-LFUCG proposed an adjustment to test period charges billed GTE South by its affiliate, GTE Data Services. This adjustment was proposed to reflect the changes from the Tax Reform Act of 1986.

The Commission has not accepted this adjustment. However, the Commission is very concerned with the affiliated relationship and the amount of services being provided to GTE South by GTE Data Services. Therefore, as with GTE Labs, the Commission will require that GTE South provide a cost/benefit study of these charges in the next rate proceeding. Moreover, information should be provided on the intercompany profit determination.

Maintenance Expenses

Central Office Conversion Maintenance Expense

The AG-LFUCG proposed a decrease to test period central office maintenance expenses in the amount of $607,159 on an

intrastate basis. The adjustment was based on information provided by GTE South explaining the test period increase in central office maintenance accounts vis-a-vis expenses for the same accounts for the previous 12-month period and a response to a similar question in GTE South's last general rate case.

In both cases GTE South clearly stated that increases in these central office maintenance expense levels were the result of digital switch conversions. GTE South's response from its last general rate case, in particular, emphasizes that abnormal expenses are incurred as a result of these conversions.[85] Given GTE South's response and the fact that the AG-LFUCG was unable to obtain budget comparisons, it proposed to reduce maintenance expenses by the net of the test period increases/decreases above the prior 12-month period for digital expenses, distribution framework, and analog and other central office maintenance.

GTE South objected to this adjustment on the basis that it could not identify any precise reason in support of the adjustment and that the adjustment was based upon a ". . . cursory review of randomly selected expense accounts. . ."[86] Mr. Giammarino goes on to present figures which illustrate that for the calendar years 1984 through 1987 central office maintenance has been relatively constant in spite of a significant growth in access lines and inflationary pressures.

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85 Staff Supplemental Request, Item 19, Case No. 9678.

86 Giammarino Rebuttal Testimony, page 91.

The Commission concurs with the AG-LFUCG's recommendation for the following reason. Perhaps the most persuasive fact supporting the concurrence is a review of the history and forecast of digital conversion activity. This review[87] reveals that prior to 1988, 28 offices or 48 percent of the total of 58 offices had been converted and were in service with digital switches by the end of the test year in this case. In 1988 and 1989, one office in each year is to go in service. In 1990 and 1991, 3 offices and 6 offices, respectively, are to be placed in service. Thereafter only 2 offices in each year during the period 1992-1995 would be converted. It is clear that the conversion activity will decrease in the years subsequent to the test year and as a result the associated nonrecurring conversion expenses should be less. The AG-LFUCG's witness has made a reasonable adjustment to account for abnormal expenses and provide for a going level of central office maintenance expense. The AG-LFUCG attempted through the discovery process to determine the exact amount of abnormal central office maintenance expense included in the test period but GTE South refused to supply budget variance detail data to make a specific adjustment.

Therefore, the Commission will accept the AG-LFUCG's intrastate adjustment to central office equipment maintenance of $607,159 resulting in an increase to net operating income of $371,672.

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87 Staff Request No. 3, dated April 5, 1988, Item 20.

Test Desk Work Maintenance Expense

The AG-LFUCG proposed to decrease intrastate subscriber line testing (Account 501) expense by 50 percent or $965,743. The foundation of the AG-LFUCG's proposal is that GTE South explained that the test period increase in this account was the result of installation of digital equipment which is non-recurring. Moreover, the AG-LFUCG contended that a portion of the adjustment should be made to transfer a portion of these costs to detariffed operations.

GTE South stated that subscriber line testing will continue to grow as new lines are added to the base unit and software modifications are required and that the AG-LFUCG's adjustment would only be appropriate in a "no growth" environment. GTE South also pointed out that subscriber line testing expenses are charged directly to detariffed operations when the trouble is isolated to the customer premise.

GTE South further explained that it recognized the need for an allocation of expenses associated with repair contact and dispatch to reflect detariffed operations and made a $360,000 intrastate pro forma adjustment to the test period.[88]

The Commission agrees with GTE South and, therefore, has made an adjustment to these maintenance expenses.

Trouble Isolation

As discussed in a subsequent section of this Order, the Commission is of the opinion that trouble isolation related to

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88 Giammarino Rebuttal Testimony, page 95.

inside wire problems should not all be deregulated. Therefore, the Commission has reinstated expenses associated with the regulated service in the amount of $167,575 on an intrastate basis. This adjustment along with the adjustment to revenues results in an increase to net operating income of $386,751.

Employee Compensation Expenses

Early Retirement Program

In 1987, during the test year in this case, GTE South implemented an early retirement program. GTE South employees who took advantage of this plan were given certain incentives to retire prior to the time they would ordinarily retire.

GTE South made no adjustment to reflect the reduction in wages and salaries either for employees who retired and were not replaced or for lower wages and salaries for employees who replaced the persons.

The exact dates vacancies were filled are unknown. Thus, the lower wages and salaries to actually be reflected in GTE South's test period expenses are unknown. However, in order to reflect a going forward level of wages and salaries, the Commission has made an adjustment of $143,707 to reflect a conservative half-year estimate of the reduction in wages and salaries using GTE South's schedules.[89] This results in an increase to net operating income of $87,970.

Employees who took early retirement were granted severance pay. Consistent with GTE South's adjustment, the AG-LFUCG

[89] Hearing Request, dated June 27, 1988, Item 54.

proposed to amortize GTE Service Corporation severance pay over a 3-year period as it is non-recurring.[90] The Commission agrees with the AG-LFUCG and has reduced GTE South's test year expenses $19,239,[91] thereby increasing its net operating income by $11,777.

The AG-LFUCG also proposed to adjust test-period operating expenses $94,845[92] to reinstate to regulated operations the reduction in pension settlement gains associated with severance pay to employees who took early retirement. GTE South allocated approximately 15 percent of this reduction to deregulated operations. The AG-LFUCG considered the allocation inappropriate because the regulated ratepayers have over the years funded pension expenses, and only recently have the deregulated operations increased to the level that any allocation would be made. The Commission agrees that the gains from pension settlements should benefit regulated operations and has reduced operating expenses accordingly, resulting in an increase to net operating income of $58,060.

Post-Test-Period Wage and Salary Increases

GTE South proposed an adjustment of $674,719 to reflect wage and salary increases which occurred subsequent to the end of the test period in this case. This adjustment represents a three to four percent increase for craft and management support and an increase of approximately five percent for management. The union

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90 DeWard Prefiled Testimony, page 77.

91 Ibid.

92 Ibid., pages 63-63.

increases occurred in March and June 1988. The management increases occurred in July 1988.[93]

The AG-LFUCG recommended that this adjustment be denied. The AG-LFUCG contended that GTE South had not recognized offsets to wage increases or productivity gains. Further, GTE South did not adjust for reductions in the work force from implementation of the early retirement program.

GTE South did make two adjustments to reflect productivity gains. GTE South made an adjustment of $96,908 to reflect productivity gains expected as a result of central office conversions to digital technology and an adjustment to revenues of $35,198 to reflect expected increases from new custom calling features. Moreover, the Commission has made an adjustment to reflect reductions in the work force from the early retirement program.

In GTE South's last general rate case, this same issue of out-of-period wage increases was discussed extensively in the Order of April 16, 1987 and again in the Order on Rehearing of October 19, 1987. In both Orders, the Commission denied the adjustment.

In the last case, the Commission reviewed the out-of-period wage increases in the context of expected overall operations and came to the opinion that the adjustment should be disallowed since an isolated adjustment for increases beyond the end of the test period might well produce a distortion in earnings relative to capital.

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[93] Staff Request No. 1 dated January 15, 1988, Item 16(L), page 2.

In this case, besides the issue of productivity gains from changes in technology and enhanced service revenue, the level of uncertainty of future operations has increased significantly because of GTE South's announcements that it is further consolidating its operations.

GTE South's witness, Mr. Giammarino, testified that GTE South projected no growth in the level of employees outside the test period.[94] Later in his testimony, however, he indicated there would be a reduction in the Lexington, Kentucky, work force sometime in 1989 as job functions are transferred to Elizabethtown, Kentucky.[95] Mr. Giammarino said there would be an undetermined number of jobs added in Elizabethtown but gave no indication if the number added in Elizabethtown would approach the reduction in Lexington.[96] Nevertheless, Mr. Giammarino did indicate that the move to Elizabethtown would result in cost savings to GTE South.[97] These savings are not reflected in GTE South's application.

Moreover, GTE South has announced a major consolidation and reorganization which may result in a change in the number of employees in the Durham General Office. This would certainly have an effect on Kentucky operations because approximately one-third of the Durham wages are allocated to Kentucky. Again, there is no

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94 Hearing Transcript, Vol. III, dated June 10, 1988, page 16.

95 Ibid., page 17.

96 Ibid., page 18.

97 Ibid.

adjustment in the current case for changes resulting from this consolidation.

In this case, as in Case No. 9678, GTE South has gone beyond the test period to adjust for a wage change without adjusting for corresponding changes in employee levels. The Commission is again very reluctant to go beyond the test period for the wage changes without having some idea of what may happen in GTE South's operations, especially the work force levels.

The Commission believes that, based on overall operations of GTE South, it would be improper to allow wage increases beyond the end of the test period when GTE South's work force may decrease significantly from changes in operations not adjusted herein. To allow GTE South to go beyond the test period and recover expenses that may not exist (i.e., to set rates on a level of employees that has a very real potential to decrease), would be unfair to GTE South's ratepayers. The Commission, therefore, denies GTE South's pro forma wage adjustment of $674,719.

The Commission, accordingly, rejects GTE South's offsetting increase to revenues and decrease to expenses to reflect gains associated with central office conversions. These actions result in an increase to net operating income $366,121.

Medical and Dental Insurance

GTE South proposed to increase its operating expenses by $769,085 to adjust for an increase in medical and dental premiums.

The AG-LFUCG contended that the proposed increase should be denied in its entirety for several reasons. First, the amount of the increase is based on projections and, therefore, is not known

and measurable. Second, the adjustment is based on the test period level of employees and any occurrence affecting the level of employees would impact this adjustment. Finally, it is inappropriate to ask ratepayers to bear the entire increase without GTE South making its employees bear some of the cost of these premiums.[98]

GTE South disputed the AG-LFUCG and justified the increase on the basis that all projections are made from actuarial studies and that the employee levels used as a basis for the projections will remain constant.[99] In addition, GTE South stated that the AG-LFUCG is incorrect in its assertion that medical and dental premiums should not be passed through to the ratepayers.[100]

The Commission is deeply concerned over the rapidly escalating medical care costs and premiums with which utility companies are faced. The Commission is also aware, as the AG-LFUCG stated, that many companies are being forced to seek alternative methods of providing health care coverage for employees. One of these alternatives, as the AG-LFUCG stated, is to require employees to share in the cost of coverage.[101] The Commission at this time is not ready to suggest to GTE South that it have its employees share in the cost of medical coverage. However, the Commission advises GTE South to closely monitor the costs of medical insurance and to

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[98] DeWard Prefiled Testimony, pages 59-60.

[99] Giammarino Rebuttal Testimony, page 81.

[100] Ibid., page 82.

[101] DeWard Prefiled Testimony, pages 59-60.

take all necessary steps to keep the cost to the ratepayers at a minimum.

The Commission believes that GTE South's projections for medical costs are actuarially sound and that the costs proposed by GTE South are based upon costs that will be incurred. The Commission has, thus, allowed GTE South's pro forma adjustment for medical and dental insurance.

Other Adjustments

Budget Department Expenses

GTE South in this case used the 1988 budget to determine its adjustments for the USoA changes and several other adjustments. As described in other sections of this Order, to the extent possible the Commission used historical amounts rather than relying on budgets. Intervenors questioned GTE South's use of budgeted information and recommended that the Commission disallow all expenses included in the test period for the budget department.

The Commission finds the adjustment proposed by the AG-LFUCG unreasonable; a major utility must forecast and plan its operations and use those plans in its management. However, the Commission cautions GTE South that if it expects to present testimony based on budgets in future cases its witnesses should be prepared to answer relevant questions.

Interexchange Carrier Billing and Collection Expenses

GTE South proposed to increase operating expenses by $2,676,735 because of an error made in the method it used to remove Interexchange Carrier ("IXC") billing and collection

expenses from regulated expense accounts, thus, resulting in an understatement of expenses.

The AG-LFUCG established that the correct adjustment should be $2,151,753 because GTE South inappropriately included fourth quarter true-ups in its calculation. Since the fourth quarter includes only one month of the test period, the AG-LFUCG is of the opinion that a more representative figure would be actual test period expenses.

It is the Commission's opinion that since this adjustment involves the correction of an error, the expenses considered should be only those expenses erroneously removed during the test period. It would be inappropriate to allow GTE South to adjust for an error by including expenses from a time frame beyond the test period. The Commission, therefore, finds the appropriate increase to GTE South's operating expenses is $2,151,753. This action results in an increase to net operting income of $356,618.

Interest Synchronization

GTE South proposed to reflect interest expense of $14,112,864 in its determination of taxes based on its proposed rate base and debt cost, including an allocation of JDIC to all components of capitalization.[102] However, the Commission using the same methodology applied to GTE South's allowed capitalization finds interest expense to be $14,692,638. This results in an increase to net operating income of $224,866.

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[102] Second Revised Giammarino Schedule 14.

This adjustment is made in accordance with past Commission practices.

Interest During Construction

GTE South reported construction work in progress ("CWIP") of $11,849,512 on an intrastate basis at the end of the test period. Of this amount, $941,943 is eligible for IDC. GTE South proposed to decrease operating revenues by $400,101 based on the end of test period level of CWIP on which IDC is accrued. GTE South used its overall cost of capital as the prescribed IDC rate, with an appropriate offset of the debt portion of 50 percent. However, the Commission finds a decrease to operating revenue of $298,751 is proper using the overall cost of capital allowed herein. This reduces net operating income by $298,751.

This adjustment is made in accordance with past Commission practices.

Lobbying Expenses

The AG-LFUCG proposed to remove $36,294 of expenses associated with lobbying activities. It has generally been the practice of this Commission to disallow for rate-making purposes the expenses attributable to lobbying activities. Accordingly, the Commission has decreased GTE South's operating expenses by $36,294, thus, increasing net operating income by $22,218.

Management Audit Expense

The AG-LFUCG proposed that the Commission reject GTE South's proposal to include amortization of its cost of the management audit conducted by this Commission. GTE South proposed to amortize the costs over a 3-year period. The AG-LFUCG stated that the

costs should not be included in this rate case unless the potential benefits resulting from recommendations in the audit are also included.[103]

As discussed during the hearing, GTE South is allowed by statute, KRS 278.255, to recover the costs of the management audit required by the Commission. The Commission rejects the AG-LFUCG proposal and herein allows GTE South's proposed adjustment to recover the costs of the management audit.

Miscellaneous Expenses - Account 7779

On Schedule 38 of his Prefiled Testimony, the AG-LFUCG's witness, Mr. DeWard, deducted from test year expenses a net amount of $50,777 for expenses incurred by GTE South for tickets for athletic functions and expenditures of a similar nature and for expenditures charged for "write-offs" of expenses which could neither be reconciled nor explained. The Commission concurs with the AG-LFUCG's adjustment since expenditures for athletic events should not be paid by GTE South's ratepayers and, further, that in the absence of any evidence, the remaining expenses are considered abnormal and non-recurring. This adjustment increases net operating income by $31,083.

Miscellaneous Other Adjustments

On Schedule 39 of his Prefiled Testimony, the AG-LFUCG's witness, Mr. DeWard, proposed to remove from the test year expenses, four items of GTE South's expenses which total $278,411 on an intrastate basis. On a combined basis this amount is

[103] DeWard Prefiled Testimony, page 63.

$382,816. Since the items are totally unrelated they will be addressed separately.

In the first adjustment, Mr. DeWard proposed to remove $42,782, on an intrastate basis, in expenses related to the purchase of a new budget system. The basis for the exclusion was that the invoice for the system was dated prior to the test year. GTE South agreed with the adjustment; however, as GTE South pointed out, the AG-LFUCG's adjustment removed the total charges to the account while the invoice amount is only $55,444 on a combined basis. Therefore, the Commission has reduced expenses by $40,323 on an intrastate basis.

The second adjustment concerns the deletion of a duplicate expense entry in recording Kentucky's portion of General Office overhead expenses. On a combined basis, AG-LFUCG's proposed reduction is $92,200. GTE South objected to the adjustment stating that the amount in question is not a duplicate level of expense, but is an entry to recognize Kentucky's share of March 1987 expenses and to establish a new standing accrual based on March 1987 activity for the month of April 1987. GTE South also pointed out that the standing accrual established in January 1987 was reversed in April 1987 resulting in an overall reduction in test period expense.

The Commission has analyzed the activity in the account in question using journal entry information[104] and the monthly operating ledgers. Because of the absence of detailed journal

[104] AG Request No. 1, Attachment II in Item 104, page 6.

entry information for the entire test period and because of very brief explanations on journal entries, each entry to the ledgers could not be examined in detail. However, after reviewing the 12 months of the test period, it appears that March 1987 is abnormally high compared to the other 11 months. Therefore, based upon its analysis, the Commission accepts the AG-LFUCG's adjustment and reduces Kentucky intrastate expenses $67,054.

The AG-LFUCG's third adjustment on Schedule 39 of $105,933 on a Kentucky combined basis was made to remove COE repairs expense which was incurred outside of the test period. GTE South agreed that the costs were outside of the test period. However, it contended that since GTE South has been earning well below its authorized rate of return, disallowance of these costs would deny its ability to recover these costs. GTE South further recommended that the costs be considered non-recurring items and amortized over 3 years.

The Commission rejects GTE South's position and accepts the AG-LFUCG's adjustment. As previously discussed, it is the purpose of this case to set GTE South's rates at a level to recover going forward costs. Therefore, the Commission has reduced GTE South's expenses by $77,042 on an intrastate basis.

The final adjustment proposed by the AG-LFUCG totals $125,857 on a Kentucky combined basis and relates to expenses associated with cancelled projects begun prior to the test period. The basis for the AG-LFUCG's proposed rejection of these expenses was that they were not representative of going forward expenses. GTE South contended that this type of activity is a normal occurrence and,

therefore, is representative of going forward expenses. The Commission agrees with GTE South and thereby rejects the AG-LFUCG's proposed adjustment.

The total effect of the Commission's decisions on these four adjustments is a decrease in Kentucky intrastate expenses of $184,419 resulting in an increase of net operating income of $112,892.

Interest on Customer Deposits

Consistent with the adjustment to reinstate customer deposits to the rate base the Commission has increased net operating income by $76,079 by adding back interest on customer deposits.

RATE OF RETURN

Capital Structure

Mr. Austin, treasurer and witness for GTE South, proposed an adjusted end-of-test-year capital structure composed of 42.66 percent long-term debt, .33 percent short-term debt, 5.07 percent in JDIC, .29 percent preferred stock, and 51.65 percent common equity. The adjustments reflect "fourth quarter 1987 financing activities consisting of the sale of $25 million of common stock and a planned first quarter 1988 sale of $50 million of common stock."[105] The inclusion of the $75 million out-of-test-year common stock sale resulted in decreasing short-term debt from 5.49 percent to .33 percent and increasing common equity from 46.17 percent to 51.65 percent of total capitalization. Mr. Austin contended that this increase in common equity was needed to offset

[105] Austin Prefiled Testimony, page 16.

GTE South's low interest coverage ratio and to maintain its current bond rating.[106]

Mr. DeWard, witness for AG-LFUCG, proposed a capital structure containing 44.93 percent long-term debt, 5.78 percent short-term debt, .31 percent preferred stock, and 48.98 percent common equity. Mr. DeWard based his proposal on GTE South's end-of-test-year capital structure with some modifications. The first adjustment was restating short-term debt and common equity to the level which existed at the end of the test year and, thus, rejecting the "company's proposal to shift components of its capital structure from short-term debt to common equity."[107] Mr. DeWard also excluded JDIC from total capitalization in arriving at his percentage figures and simply allocated the JDIC proportionately among the capital structure components.

The Commission has traditionally used end-of-test-year capital structures and is of the opinion that the inclusion of the $75 million out-of-test-year common stock sale would result in a non-representative capital structure for GTE South. Therefore, the Commission rejects the proposed adjustments by GTE South to short-term debt and equity. Further, the Commission will in this case, as in previous cases, continue to allocate JDIC proportionally among the capital structure components. It is, therefore, the Commission's opinion that for rate-making purposes the capital structure for GTE South should be as follows:

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106 Ibid., page 18.

107 DeWard Prefiled Testimony, page 18.

	Amount	Percent
Long-term Debt	$620,276,000	44.93
Short-term Debt	79,800,000	5.78
Preferred Stock	4,207,000	.31
Common Equity	676,041,000	48.98
	$1,380,324,000	100.00

Cost of Debt

Both Mr. Austin and Mr. DeWard proposed a cost of long-term debt of 9.11 percent and a cost of preferred stock of 4.85 percent based on end-of-test-year embedded cost.[108] Mr. Austin further testified that GTE South's cost of short-term debt was 6.98 percent which was the actual rate on October 31, 1987. Mr. DeWard also concurred with this rate. However, Mr. Austin applied the 6.98 percent to an adjusted total of $4,800,000 which reflects the repayment of all prior short-term debt, at various interest rates, from the sale of $75 million in common stock. However, the end-of-test-year short-term debt of $79,800,000 has an embedded cost of 7.35 percent.[109] Since the Commission has determined that a $79,800,000 level of short-term debt will be used in GTE South's capital structure, the Commission is of the opinion and finds that the cost of short-term debt should be 7.35 percent. The Commission further finds that the cost of long-term debt and

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[108] Austin Prefiled Testimony, Schedules 4 and 3, page 2, respectively.

[109] Staff Request No. 1, dated January 15, 1988, Item 2b.

preferred stock should be 9.11 percent and 4.85 percent, respectively.

Return on Equity

Mr. Austin recommended a return on equity ("ROE") of 14.25 percent. His recommendation was based on his analysis which included a review of the current economic conditions, GTE South's changing risk status, a quarterly discounted cash flow ("DCF") model and a risk premium study. A primary concern to Mr. Austin was the increasing business risk of telephone companies which has been brought about by regulatory and federal court rulings, economic pricing, technological advances, and changing industry boundaries. Mr. Austin believes that this increase in uncertainty has raised investors' concerns over GTE South's future earnings and to the potential of a deteriorating financial position.

Also in his testimony, Mr. Austin recommended adjustments to the standard or annual DCF model. The annual DCF model assumes dividends are paid once per year while, in fact, most utilities pay their dividends quarterly. This provides investors the "opportunity" to reinvest their dividends and, therefore, compound their return. To account for this compounding effect, Mr. Austin has recommended the use of a quarterly DCF model to provide a more proper measure of the investors' required rate of return. This model assumes the reinvestment of all dividends until the end of the year at the investors' required rate of return. Thus, the investors' required return is measured as an annual effective return based on quarterly compounding. A second adjustment to the DCF model was made to account for and include a 5 percent

allowance for financing costs and market pressure in the cost of equity.

Mr. Austin applied his adjusted DCF model to a group of (1) seven publicly traded utility companies; (2) six non-Bell telephone companies; and (3) to seven Bell regional telephone companies. Mr. Austin used the group of utility companies as a check on his estimates of ROE resulting from the analysis performed on the Bell and non-Bell companies.

Mr. Austin cited several studies showing that analysts' dividend and earnings growth projections were better predictors of future growth than a company's historical growth rates. For this reason, Mr. Austin primarily used growth projections provided by Merrill Lynch, Value Line Investment Survey, and the Institutional Brokers Estimate System for his three groups of companies in his DCF analysis. Mr. Austin's average ROE for each of the above three groups was 14.3 percent, 14 percent, and 13.4 percent, respectively. Based on his DCF analysis, Mr. Austin concluded that a 13.8 percent ROE with a range of 13.4 to 14.3 percent was appropriate considering current market conditions and GTE South's increased business risk.

A second method Mr. Austin used in estimating the ROE was the risk premium method. A "risk premium" is the return on equity investors require above the return currently available on corporate bonds. Mr. Austin analyzed several published studies and performed a study of his own in coming to a conclusion that equity investors require a four to five percent risk premium above the expected yield on GTE South's long-term debt issues. Based on

current bond market conditions and the average yields on "A" rated telephone companies of 10.25 to 11 percent, Mr. Austin concluded that investors expect a long-term yield of 10.5 percent on GTE South's long-term debt. Adding the prior stated risk premium of 4 to 5 percent to the 10.5 percent bond yield results in an expected ROE of 14.5 to 15.5 percent.

Based on his analysis of the economic conditions, the Quarterly DCF model, and the risk premium study Mr. Austin has estimated a ROE of 13.8 to 15.0 percent, with a recommendation of not less than 14.25 percent.

Dr. Furst, president of Furst & Associates and witness for GTE South, recommended a return on equity of 14.0 to 14.25 percent. Dr. Furst's recommendations were determined based on his DCF and risk premium analysis of 7 regional telephone holding companies, 10 comparable risk telephone companies, 21 comparable risk electric utility companies, and 15 comparable risk industrial companies.

In his analysis, Dr. Furst also recommended an adjustment to the annual DCF model in order to reflect the payment of dividends on a quarterly basis. Therefore, in computing cost of equity for the comparable risk companies Dr. Furst used a Quarterly DCF model with growth estimates based on financial services forecasts of growth in dividends and earnings per share, and the current quarterly dividends obtained from Value Line Investment Survey. Dr. Furst's model also included a five percent flotation cost.

Dr. Furst also used a risk premium analysis in estimating ROE. A 1985 study by Furst and Associates found historical risk

premiums for Standard and Poor's 500 composite stocks over high-grade corporate bond rates to range from 4.3 to 9.8 percent.[110] Dr. Furst used a range for market risk premiums of 4.5 to 6 percent, which was at the low end of his study. He made further downward adjustments to the risk premium by multiplying the risk premium by the average beta for each industry group.[111] The resulting risk premium was added to the current high grade corporate bond rate of 10.25 percent as reported in Merrill Lynch's Fixed Income Weekly.[112] The cost of equity ranged from 13.9 percent to 16.5 percent and included 30 basis points to adjust for flotation costs.

Dr. Weaver, economist and principal with M.S. Gerber & Associates and witness for the AG-LFUCG, recommended a return on equity in the range of 11.0 to 12.50 percent. Dr. Weaver used the annual DCF model in making his determination on the cost of equity and the earnings-price ratio method to confirm his findings. In his analysis, Dr. Weaver took capital market data from 2 time periods, 1987-88 and 1977-80. The current data was used because it reflected investor expectations regarding future market conditions. The historical period was used because of its economic similarities with the present and to further help in verifying his findings. The above analysis was performed on GTE South and a group of six independent investor-owned telephone

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[110] Furst Prefiled Testimony, page 21.

[111] Ibid., page 22.

[112] Ibid.

companies. In the DCF model, dividend yield was determined by dividing the current annualized dividend by the average monthly stock price over 1987-1988. Dr. Weaver estimated the growth component of his DCF model by the earnings retention method (b x r) which is the earnings retention ratio multiplied by the return on book equity. Dr. Weaver's DCF results for the current period were 11.44 percent and the results for the 1977-80 period was 14 percent. Dr. Weaver noted that inflation is about 2 to 3 percent lower today than it was in 1977-80.[113] Thus, the range of 11.5 to 12.5 percent is slightly below the 1977-80 period, but "is sufficiently above the current period's findings to allow the uncertainty regarding for future growth of the economy, inflation, and interest rates."[114] Dr. Weaver did not recommend any adjustments to allow for flotation costs.

In this case, witnesses for GTE South have asked the Commission to accept a ROE based on a Quarterly DCF model as opposed to an annual DCF model. In its evaluation of the testimony, the Commission believes that the only real difference between the annual and Quarterly DCF model is the period over which future cash flows are discounted. In the traditional annual model, dividend payments are assumed to be made at the end of each year. Therefore, the ROE that equates the present value of all future dividends with the stock's current price is an annual percentage figure. However, in the Quarterly DCF model, dividend payments

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[113] Weaver Prefiled Testimony, page 24.

[114] Ibid.

are assumed to be made at the end of each quarter and are discounted on a quarterly basis. Therefore, the ROE that equates the present value of all future quarterly dividends with the current price is a quarterly percentage figure. This is a very important distinction, because while the Commission agrees that a Quarterly DCF model could be used in determining ROE, it strongly disagrees with Mr. Austin's and Dr. Furst's application of the model. Mr. Austin and Dr. Furst have taken the quarterly ROE and compounded it for four quarters to produce an effective annual yield an investor would receive if the dividend were reinvested each quarter at the quarterly rate. However, the company does not need to pay the effective rate if it is making quarterly dividend payments. Once the company has paid its quarterly dividend then it has met its obligation to provide the investor the "opportunity to reinvest" and, thus, earn his required rate of return, if he so chooses. The company no longer has the responsibility to provide a return on a dividend that has been paid. Therefore, for rate-making purposes the cost of equity to the firm is the computed quarterly rate or, on a yearly basis, a nominal annual rate equal to four times the quarterly rate.

Therefore, it is the Commission's opinion that the Quarterly DCF model be rejected in this case, not on its validity, but on the basis that it has been misapplied. The Quarterly DCF model, as applied by Mr. Austin and Dr. Furst, has overstated the ROE because they have used the effective return rather than the nominal return. The Commission further finds that, if earnings have been inadequate in the past, Dr. Weaver's use of the b x r

method can understate the growth rate component and, thus, the investor's required return in the DCF analysis. The lower growth rate derived from the b x r method results in a lower allowed return which could result in lower earnings and a lower retention ratio and then a still lower growth rate component and so on. A downward trend could develop and, thus, weaken the financial integrity of GTE South.

In addition, while the Commission understands that investors may require a higher ROE in order to recover flotation costs incurred in public stock offerings, GTE South has not been able to specifically identify these costs. Furthermore, if these costs have been incurred, GTE South has neither demonstrated nor convinced the Commission that these costs have not been recovered as expense items included in the GTE South contract with GTE Service Corporation.[115] Therefore, the Commission is of the opinion and finds that no allowance should be made to ROE for the recovery of flotation costs.

Therefore, the Commission having considered all of the evidence, including current economic conditions, is of the opinion that a return on equity in the range of 12.25 to 13.25 percent is fair, just, and reasonable. A return on equity in this range would allow GTE South to attract capital at a reasonable cost to ensure continued service and to provide for necessary expansion to meet future requirements, and also result in the lowest possible

[115] Haddad Prefiled Testimony, Haddad Schedule 4, page 2.

cost to ratepayers. A return of 12.75 percent will best meet the above objectives.

Rate of Return Summary

Applying rates of 9.11 percent for long-term debt, 7.35 percent for short-term debt, 4.85 percent for preferred stock, and 12.75 percent for common equity to the recommended capital structure approved herein produces an overall cost of capital of 10.77 percent. The additional revenue granted will provide a rate of return on net investment of 10.60 percent which the Commission finds to be fair, just, and reasonable.

REVENUE REQUIREMENTS

The Commission, based on GTE South's adjusted operations, has determined that GTE South is entitled to increase its rates and charges on an intrastate basis by $7,947,185 determined as follows:

Required Net Operating Income	$35,018,978[116]
Adjusted Net Operating Income	30,166,758
Deficiency	4,852,220
Retention Factor	.6105584
REQUIRED INCREASE	$7,947,185

RATE DESIGN

In Staff Request No. 1, Item 8b, GTE South was requested to file a billing analysis for the test year in accordance with 807 KAR 5:001, Section 10(2)(b). GTE South did not file full test year information for all services but, rather, provided billing analyses reflecting end-of-period billing units, rates, and

[116] $325,153,000 X 10.77% = $35,018,978.

revenue for only those services for which a rate adjustment was proposed.[117]

GTE South's failure to file a complete billing analysis substantially limits the Commission to a review of only those rates GTE South proposes to change. The Commission cautions GTE South that future rate case filings must include a complete test year billing analysis in compliance with the regulation.

Custom Calling

On February 5, 1988, GTE South filed proposed tariffs renaming its existing custom calling tariff, Smart Call, revising certain monthly rates for single features, grandfathering existing package rates, and establishing three new package feature offerings. The tariff filing was incorporated into this case by Order of the Commission dated March 8, 1988.

Custom calling or Smart Call features are enhanced services available to customers in addition to basic telephone service. GTE South anticipates new customers will be gained as a result of the proposed restructuring and that existing customers will migrate toward the new package features.[118]

The billing analysis filed by GTE South shows annualized end-of-period revenue of $924,257 and revenue from proposed rates

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[117] Notice Exhibit 3, Schedule 1 and Staff Request No. 2, dated March 4, 1988, Items 62-2 and 63.

[118] Ibid., Item 62-2(e).

and restructuring of $1,061,174, an increase of $136,917 over test period revenue.[119]

The Commission is of the opinion that the proposed tariff is reasonable and should be approved.

Touch Calling

GTE South proposed to reduce its monthly rates for touch calling service for residence lines by $.50 and business lines by $1.25, resulting in decreased revenue of $1,101,159. In support, GTE South stated that station equipment is now readily available which permits switching between tone and dial pulse operation, and allows the customer the convenience of push button dialing but promotes network inefficiency by perpetuating dial pulse signalling. GTE South proposed to eventually eliminate charges for touch calling service.[120]

The Commission agrees with the promotion of touch calling through reduction of rates; however, it is of the opinion that such reduction should be more gradual and has adjusted the proposed rate accordingly.

Toll Terminal Service

GTE South proposed to eliminate its toll terminal service classification and reclassify this service as PBX access lines. In support of this proposal, GTE South stated the majority of these services function as switched access interconnecting facilities, and the proposed change will ease the administrative

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[119] Ibid., Item 62-2, Attachment I.

[120] Wellemeyer Prefiled Testimony, pages 12-13.

burden of maintaining separate distinction for like classes of service.[121] At the end of the test period, there were 356 toll terminal units in service which produce total annual revenue of $153,128.[122] However, at the hearing, GTE South's witness, Mr. Wellemeyer, testified that a PBX access line makes available both incoming and outgoing toll services as well as local access while toll terminal service limits the subscriber to outgoing toll calls only.

While both services may function as switched interconnection facilities, PBX access lines provide substantially greater calling capability than toll terminal service. Thus, there is no justification for charging equal rates.

Mileage Charges

In Case No. 9678, mileage charges for Intraexchange Private Line Service and similar private, channel-based services were equalized at $2.61 per 1/4 mile. GTE South proposed to increase this rate by 92 percent to $5 per 1/4 mile. In support, GTE South filed a fully allocated cost study showing a cost of $8.60 per 1/4 mile.[123] The stated purpose of this increase is to bring rates in line with costs.

The Commission agrees that an increase in mileage rates is appropriate, but is of the opinion that an increase of this

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[121] Ibid., page 10.

[122] Notice Exhibit 3, Schedule 1, pages 5-9.

[123] Staff Request No. 2, dated March 4, 1988, Item 61, page 3, and Hearing Transcript, Vol. V, dated June 14, 1988, page 47.

magnitude is too abrupt and that a more gradual approach to a cost based rate is appropriate. The Commission has adjusted the proposed rate accordingly.

Special Line Conditioning

GTE South proposed to eliminate charges for Special Private Line Conditioning which would result in decreased revenue from this service of $341,370. However, in his testimony at page 12, Mr. Wellemeyer stated costs associated with these rate elements were included in the study of private channel facility costs. At the hearing, he identified those costs in the cost study filed in support of the proposed mileage charge.[124] The Commission accepts this proposal.

Rate Relationships

GTE South proposed to change the rate relationships between various service classifications as a step toward its goal of equal access rates for all business customers and, ultimately, equal access rates for all classes of service.[125]

GTE South proposed to change the relationship of PBX access line rates to residence single party from 4.625 to 3.75 and business single party to residence single party from 2.5 to 2.75. At the hearing, Mr. Wellemeyer testified that with the advanced CPE available customers can order business one-party service which can be used with a customer-provided PBX at the lower one-party

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124 Ibid., and Hearing Transcript, Vol. V, dated June 14, 1988, pages 49-50.

125 Wellemeyer Prefiled Testimony, pages 5-9.

business rate.[126] He further stated that the increase in the relationship of business single party is designed to offset the revenue burden which would shift to residential customers as a result of the change in the PBX access line relationships.[127] The current rotary line rates represent the differential between the business single party and PBX access line rate. GTE South proposed to reduce its rotary line rate in order to retain this differential which would otherwise be altered by the change in the rate relationships of PBX access line and business single party rates.

The Commission believes a change in rate relationships is reasonable. However, under GTE South's proposed PBX access and business single party rate relationships, the reduction in rotary line rates necessary to equal the PBX/business differential still results in a revenue shift to residential customers. The Commission is of the opinion this is unjust and unreasonable. The change in the rate relationships between business single party and residence single party rates from 2.5 to 2.75 should be approved; however, the proposed rate relationship between PBX access lines and residence single party should be denied and established at 4.0. The business rotary line rate should represent the differential between the PBX access line rate and the business single party rate.

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126 Hearing Transcript, Vol. V, dated June 14, 1988, pages 70-72.

127 Wellemeyer Prefiled Testimony, pages 8-9.

GTE South also proposed to change the rate relationships of both business and residential 2-, 4-, and 8-party services to single party services for the purpose of promoting transition to single party service. No studies or other evidence were presented to justify this change.

Four and 8-party service were grandfathered as of GTE South's last general rate case, Case No. 9678. GTE South's witness verified that evidence in that case showed approximately 10,909 multi-party customers compared to the current level of 6,872 4- and 8-party customers, a decrease of approximately 37 percent.[128] Further, a report filed with the Commission showing multi-party subscribers, held orders, and requests for regrades[129] as of December 1987 shows several areas where there is a high concentration of 4- and 8-party customers. GTE South could not state that residential single party services would be available to any customer upon request. Further, GTE South agreed that increasing the rates in this manner could cause a customer to go off service because he could not afford service at the higher rate.[130] In addition, multi-party service is a lesser level of service than single party service and, as such, does not provide the same value of service.

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[128] Hearing Transcript, Vol. V, dated June 14, 1988, page 34.

[129] Recognized by reference, Ibid., page 10.

[130] Ibid., Vol. IV, dated June 13, 1988, page 171.

The Commission is of the opinion that this change in rate relationships between business and residence single party service and multi-party services is unjustified and should be denied.

Joint User Service

Joint user service was grandfathered in August 1982 and now has only three remaining subscribers. GTE South proposed to eliminate this service and reclassify the remaining customers to business single party.[131] Based on current rates, these customers would experience an increase of approximately 100 percent. Further, GTE South's tariff provides that existing customers may continue on this service as long as they remain at their present location. The Commission is of the opinion that GTE South should abide by this tariff provision. Therefore, the proposal to eliminate joint user service should be denied.

1.544 Megabit Access Line and Special Transport

GTE South proposed to increase and restructure both the 1.544 megabit access line and special transport rates. Mr. Wellemeyer's Exhibit 3, Schedule 1, page 17, shows only 8 access line units at end-of-period and no special transport units. The proposed changes are intended to bring charges more in line with cost elements.[132] This proposed restructuring is reasonable and should be approved.

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[131] Staff Request No. 1, dated January 15, 1988, Item 8(h); Tariff S103.1; and Wellemeyer Prefiled Testimony, page 14.

[132] Wellemeyer Prefiled Testimony, pages 14-15.

Trouble Isolation

Trouble isolation is the determination of whether telephone service trouble is inside or outside a customer's premises. GTE South proposes to deregulate trouble isolation services by eliminating the regulated Maintenance of Service charge. This charge was assessed when trouble was isolated to CPE. Based on the cross-examination of Mr. Wellemeyer,[133] it appears that if trouble was isolated to inside wire, customers have been charged an "unregulated" fee. If the customer subscribed to the company's unregulated maintenance plan, neither regulated nor "unregulated" Maintenance of Service charges were assessed. Therefore, based on the method that charges were assessed, it appears that GTE South has been treating trouble isolation related to inside wire problems as a deregulated service, although trouble isolation related to CPE problems were treated as regulated. The rationale behind this inconsistency is unclear.

In response to the Commission's Staff Request No. 2, Item 62-1(a) and at the hearing,[134] GTE South has admitted that there is no basis for its position in either FCC or Commission Orders. In fact, in Administrative Case No. 305, The Detariffing of the Installation and Maintenance of Inside Wire, the Commission ordered[135] South Central Bell Telephone Company to allocate $.90 of its $1.20 inside wire maintenance plan to regulated revenues

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[133] Hearing Transcript, Vol. V, dated June 14, 1988, page 26.

[134] Ibid., page 21.

[135] By Order dated January 23, 1987.

specifically for trouble isolation services, which is a clear indication that the service was not deregulated. The Commission is still of the opinion that this service should remain regulated and that a generic proceeding would be required to deregulate any service in order to insure adequate participation by all affected utilities.[136] In addition, there has been no indication that a practical alternative exists to telephone utility provision of the service. Indeed, until appropriate network interface devices are universally available, the provision of the service by competitors is impossible under some circumstances.[137]

However, the Commission does recognize the need to provide this service on an unbundled, optional basis, at the very least to encourage customers to verify to the extent possible that trouble is not occurring in customer provided equipment or wiring before reporting problems to the telephone company. Therefore, the Commission will approve an optional monthly rate of $.35 and retention of the existing Maintenance of Service charge. Tariff section S4 must be modified to clarify that this charge will be assessed for trouble found in inside wiring in addition to

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[136] It should be noted that trouble isolation services are not unique to telephone utilities. In fact, the customer premise equipment used in conjunction with the provision of other utility services, such as gas and water pipes, and electrical wiring, have been traditionally unregulated areas. However, it is not a standard practice to charge unregulated rates for trouble isolated to these areas.

[137] This should not be construed as a suggestion to prematurely replace existing station protectors in order to facilitate the deregulation of the service, although it is expected that new installations and necessary replacements will use network interface devices with customer testing capabilities.

customer provided equipment. All customers presently subscribing to what had been erroneously considered to be the unregulated trouble isolation plan will be considered to be subscribers to the regulated trouble isolation plan.

The Commission has calculated revenues and expenses based upon confidential information which has been filed. In order to protect the confidential nature of the material it will not describe these calculations here. It should be noted that the Commission has attempted to obtain allocations of expenses and revenues from GTE South.[138] However, GTE South has consistently replied that, for various reasons, the requested allocations were not possible.

Collection of Unbilled Revenues

In accordance with the Commission's Order of July 29, 1988, the rates granted herein should be effective for services rendered on and after August 1, 1988. In order to cover the lag between rates actually charged for services between August 1, 1988 and September 1, 1988, and rates prescribed in this Order, GTE South should compute the charges for services rendered during that time at the rates granted herein. The difference between the resulting charges and the actual charges should be billed in two equal installments in addition to the customers' current billings except in instances where service is being discontinued. Where service is being discontinued either upon notice by GTE South in

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[138] Staff Request No. 2, dated March 4, 1988, Item 62-1(c); Staff Request No. 3, dated April 5, 1988, Items 25-28; and Hearing Request Items 32-35.

accordance with the regulations or upon request by a customer(s), the entire difference owing may be included on the next bill rendered to such customer(s).

A separate line shall be included on each bill rendered showing the total amount of the adjustment to the bill, including both basic charges and any non-recurring charges resulting from the difference in the actual rates charged and those approved herein. This line item should be identified as "Change in rates for August 1 - August 31, 1988."

Within 30 days of the end of the 2-month period during which the additional amounts are billed, GTE South shall file with the Commission a schedule showing the total additional amount billed to its customers.

FINDINGS AND ORDERS

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

1. The rates and charges proposed by GTE South would produce revenues in excess of those found reasonable herein and should be denied upon application of KRS 278.030.

2. GTE South should continue to evaluate its transactions with its affiliated corporations to determine cost benefit relationships and to determine the benefit to Kentucky ratepayers. Such evaluations should include, but not be limited to, GTE Service Corporation, GTE Directories, GTE Data Services, GTE Laboratories, and the GTE Supply Division.

3. GTE South should continue to evaluate its allocation of General Office expenses to the Kentucky operations and determine the cost benefit relationship for the Kentucky ratepayers.

4. GTE South's proposed Smart Call tariff should be approved for services rendered on and after August 1, 1988.

5. GTE South's proposals to change rate relationships between 4- and 8-party service and business and residential single party service, to reclassify toll terminal service to PBX access line, and to eliminate joint user service, and reclassify those customers to business single party service should be denied.

6. GTE South's proposals to eliminate charges for special private line conditioning, to restructure its 1.544 Megabit access line and special transport rates, and to change the rate relationship of business single party to residence single party from 2.5 to 2.75 should be approved effective on and after August 1, 1988.

7. GTE South's proposal to change the rate relationship between PBX access lines and residence single party from 4.625 to 3.75 should be denied, and the relationship should be established at 4.0, effective on and after August 1, 1988.

8. GTE South should modify its tariffs for trouble isolation as set forth in Appendix A.

9. The rates in Appendix A should be approved as the rates and charges GTE South should charge its customers for service rendered on and after August 1, 1988.

10. GTE South should collect from its customers the unbilled revenues for the period of August 1, 1988 through August 31, 1988 in accordance with the procedure set forth above.

11. Within 30 days from the date of this Order, GTE South should file with this Commission its revised tariff sheets setting out the rates approved herein.

12. GTE South should file by December 1, 1988 a schedule showing the total additional amount billed to its customers for service between August 1, 1988 and August 31, 1988.

IT IS THEREFORE ORDERED that:

1. The rates and charges proposed by GTE South would produce in excess of those found reasonable herein and be and they hereby are denied.

2. GTE South's proposed Smart Call tariff be and it hereby is approved for services rendered on and after August 1, 1988.

3. GTE South shall modify its tariffs for trouble isolation as set forth in Appendix A.

4. The rates in Appendix A be and they hereby are approved as the rates and charges GTE South shall charge its customers for service rendered on and after August 1, 1988.

5. GTE South shall collect from its customers the unbilled revenues for the period of August 1, 1988 through August 31, 1988 in accordance with the procedure set forth above.

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

7. GTE South shall file by December 1, 1988 a schedule showing the total additional amount billed to its customers for service between August 1, 1988 and August 31, 1988.

8. GTE South shall comply with findings 2, 3, 5, 6, and 7 above as if they were so Ordered.

Done at Frankfort, Kentucky, this 1st day of September, 1988.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

Chairman Richard D. Heman, Jr.'s concurring opinion is attached.

ATTEST:

Executive Director

CONCURRING OPINION OF RICHARD D. HEMAN, JR.

Case No. 10117 - GTE South

I concur in the Opinion and Order.

The complexities of this case and its evolution clearly demonstrate the need for rate case field audits by the Commission Staff. This is acknowledged by General Telephone at page 7 of its comments filed July 14, 1988, with respect to the management audit. Thomas DeWard, witness for the Attorney General, recommends this procedure at page 82 of his prefiled testimony.

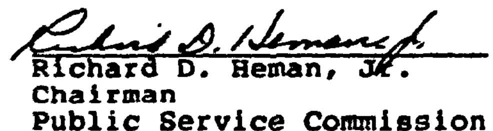
GTE:

> ". . . GTE South feels that on-site audits by the Commission Staff would facilitate the data gathering process while affording yet another opportunity to focus on the cricital issues of a proceeding. . . ."

Mr. DeWard:

> "I recommend that as in most other jurisdictions, the Staff make on-site reviews and audits where company data can be evaluated and authenticated. This will allow the Commission a much broader insight into Company operations and it will provide assurance that Company provided data has been subject to an independent review."

The Commission Staff now performs on-site rate case audits extensively in cases involving small utilities - effectively, in my opinion. The Staff findings and positions are set forth in a Staff Report. We must extend this effort to cases involving the larger utilities as soon as possible.



Richard D. Heman, Jr.
Chairman
Public Service Commission

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 10117 DATED 9/1/88

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

S2. GENERAL REGULATIONS

S2.3 Establishment And Furnishing of Service

S2.3.17 Deleted

S3. BASIC LOCAL EXCHANGE SERVICE

S3.2 Monthly Exchange Rates

S3.2.1 Flat Rate Service

a. The rate group schedule is applied on the basis of the number of primary stations and PBX access lines within the local calling area, including the primary stations and PBX access lines of other telephone companies, within the same local calling area.

CLASS AND GRADE OF SERVICE	RATE GROUP 1 0 - 6,000	RATE GROUP 2 6,001-12,000	RATE GROUP 3 12,001-25,000
BUSINESS			
One-Party Access Lines	$31.98	$35.20	$38.69
Two-Party Access Lines	27.18	29.92	32.88
Four and Eight Party Access Lines*	22.39	24.64	27.08
PBX Access Line	46.52	51.20	56.68
Semipublic Service	58.15	64.00	70.35

S3. BASIC LOCAL EXCHANGE SERVICE

S3.2 Monthly Exchange Rates

S3.2.1 Flat Rate Service (continued)

CLASS AND GRADE OF SERVICE	RATE GROUP 1 0 - 6,000	RATE GROUP 2 6,001-12,000	RATE GROUP 3 12,001-25,000
RESIDENCE			
One-Party Access Lines	$11.63	$12.80	$14.07
Two-Party Access Lines	9.30	10.24	11.26
Four and Eight Party Access Lines (2)*	8.14	8.96	9.85

	EXCHANGES	EXCHANGES	EXCHANGES
	Albany	Campbellsville	Berea
	Bradfordville	Grayson	Burnside
	Bryantsville	Hazard	Cecilia
	Burkesville	Hustonville	Glasgow
	Columbia	Leatherwood	Hodgenville
	Ewing	Leitchfield	Nancy
	Flemingsburg	Morehead	Paint Lick
	Garrison	Olive Hill	Somerset
	Greensburg	Vicco	South Hardin
	Hillsboro		
	Lancaster		
	Lebanon		
	Liberty		
	Loretto		
	Monticello		
	Owingsville		
	Salt Lick		
	Scottsville		
	Sharpsburg		
	Tollesboro		
	Tompkinsville		
	Vanceburg		

S3. BASIC LOCAL EXCHANGE SERVICE

S3.2 Monthly Exchange Rates

S3.2.1 Flat Rate Service (continued)

CLASS AND GRADE OF SERVICE	RATE GROUP 4 25,001-50,000	RATE GROUP 5 50,001-150,000
BUSINESS		
One-Party Access Lines	$42.63	$46.81
Two-Party Access Lines	36.24	39.79
Four and Eight Party Access Lines*	29.84	32.77
PBX Access Line	62.00	68.08
Semipublic Service	77.50	85.10
RESIDENCE		
One-Party Access Lines	$15.50	$17.02
Two-Party Access Lines	12.40	13.62
Four and Eight Party Access Lines (2)*	10.85	11.91

	EXCHANGES	EXCHANGES
	Ashland	Lexington
	Catlettsburg	Midway
	Elizabethtown	Nicholasville
	Greenup	Versailles
	Meads	Wilmore
	Russell	
	South Shore	

(2) Four-party residential service is not offered in Zone 1 areas; in Zone 2 and beyond it is limited to existing customers at present locations only.

* 4 and 8-party Zoned Exchange Service is an offering limited to existing customers at present locations only.

S3. BASIC LOCAL EXCHANGE SERVICE

S3.7 Rotary Line Service

S3.7.2 Rates

a. The rate for each individual rotary line in use is the applicable monthly rate for individual line service, in addition to the following rates for each rotary number. The rate groupings are the same as those specified in Section S3.

Rate Group	Business Monthly Rate*	Residence Monthly Rate*
1	$14.54	$ 9.89
2	16.00	10.88
3	17.59	11.96
4	19.37	13.18
5	21.27	14.47

* Not applicable to rotary line service provided in connection with PBX lines or WATS Service.

S.4 SERVICE CHARGES

S4.7 Maintenance of Service Charge

The customer shall be responsible for payment of service charges shown below for each visit by the Telephone Company to the premises of the customer, or authorized user, where the difficulty or trouble report results from the use of equipment provided by the customer or authorized user. The charge does not include any further isolation work beyond the Telephone Company's specified demarcation point.

Payment for this service is provided under two options:

1. Under Option I, the customer pays on a monthly recurring charge basis per exchange access line per premises.

	Monthly Rate
(a) Residence	$.35
(b) Business	.35

2. Under Option II, the customer pays on a nonrecurring charge basis per visit.

   (a) First 30 minutes, each premises

Residence	$45.60
Business	45.60

S.4 SERVICE CHARGES

S4.7 Maintenance of Service Charge (continued)

(b) Each additional 30 minutes or fraction thereof, each premises

	Monthly Rate
Residence	$18.95
Business	18.95

3. Customers may subscribe to Other Residence and Business Service (Option III) for further isolation services which are provided as detariffed and deregulated services.

S9. FOREIGN EXCHANGE SERVICE AND FOREIGN CENTRAL OFFICE SERVICE

S9.2.2 Rates

a. The following charge applies to each circuit furnished in addition to the applicable zone rate for the service desired.

	Monthly Rate
(1) Each quarter mile or fraction thereof, circuit measurement, between the Central Office from which the customer would normally be served and the Foreign Central Office	$3.91

b. DELETED

S12. ETSX AND CENTREX SERVICE

S12.1 ETSX Service

S12.1.4 Rates

	Nonrecurring Charge	Monthly Rate
b. ETSX Main Terminations within the Zone 1 and serving Central Offices area	***	$28.75

** The ETSX Main Termination rates apply in addition to the Common Access Line Charge (CALC shown in Tariff P.S.C. Ky. No. 6.

S12. ETSX AND CENTREX SERVICE

S12.1 ETSX Service

S12.1.4 Rates (continued)

		Nonrecurring Charge	Monthly Rate
j.	ETSX Service Options		
(1)	Attendant Consoles, each	$330.00	$142.05
(2)	Group Use Service, per system arranged	$99.00	-
(3)	Remote Access, (where available) - An authorized party (using Touch Call instrument) may dial directly into the system to gain access to facilities such as WATS, FX trunks, etc., each line	$27.50	$11.75
(4)	Remote Access Line,	ETSX station rates and charges	
(5)	Call Pickup Display - Facility for displaying the identity of station which is part of one or more pickup groups, each unit		
	11 line display	$44.00	$ 9.10
	24 line display	52.80	12.85
(6)	Dial Access Paging - Allows attendant(s) and station users to activate signaling equipment with a code signal corresponding to the called code, each code	$27.50	$18.55
(7)	Dictation Access and Control - Provides user with dial access to customer provided centralized dictation equipment* and has dial control of all normal dictation system features, each port	$291.50	$55.60

* Equipment must be compatible with Touch Call.

S12.1 ETSX Service

S12.1.4 Rates (continued)

		Nonrecurring Charge	Monthly Rate
(8)	Meet Me Conference - Without attendant assistance, a station user may set up a conference in which, at a pre-determined time, all conferees meet in conference by dialing the conference number, each access code		
	Six Party	$110.00	$49.40
	Eleven Party	181.50	96.35
(9)	Dial Up Conference - A station user may call a number of stations and/or trunks into conference without the aid of the attendant, each code		
	Six Party	$110.00	$49.40
	Eleven Party	181.50	96.35
(10)	Speed Call- Station user can place outgoing calls to numbers by dialing an access code plus a one or two digit code		
	Station, 30 Number List, each list	$11.00	$3.70
	Station, 8 number, each line	11.00	3.10
	Station, 30 Number, each line	11.00	6.20
(11)	Recorder Intercept - Announcer - Incoming calls to unassigned stations will be intercepted by a recorded announcement, each recorder	$55.00	$55.60
(12)	Multi-line Hunting - A group of lines arranged so that calls to a single number will cause the system to hunt across the lines in the group and seize the first idle line, each four line group	$13.20	$ 2.00

S12. ETSX AND CENTREX SERVICE

S12.1 ETSX Service

S12.1.4 Rates (continued)

		Nonrecurring Charge	Monthly Rate
(13)	Shared Attendant Service - Arrangements in which two or more sub groups of the same system may share attendants, each system	$110.00	$9.88
(14)	Dial Call Pickup - Allows a station user within a call pickup to answer any other ringing station within the pickup group,		
	Each 11 line group	$ 36.30	$4.10
	Each 24 line group	79.20	8.90
(15)	Direct Call Pickup - Station user can answer calls ringing on any other station within the system by dialing a code, each system	$ 22.00	$12.35
(16)	Most Economical Route Selection, (where available) - Allows the system to choose automatically the least cost facilities over which to route outgoing calls; upon encountering a busy, the system automatically queues outgoing calls on a priority basis, each group	$275.00	$154.40
(17)	Music On Hold, (where available) - Provides centralized availability of customer provided audio source for system wide distribution to all "held call" conditions, each system	$ 27.50	$ 24.70
(18)	Call Queueing-Outgoing, (where available) - System automatically queues outgoing calls on a priority basis, each group	$165.00	$111.20

S12. ETSX AND CENTREX SERVICE

S12.1 ETSX Service

S12.1.4 Rates (continued)

		Nonrecurring Charge	Monthly Rate
(19)	Advanced Toll Restriction, (where available) - Denies selected station lines completion of dialed outgoing calls to selected office and area codes, each line	$ 55.00	$ 19.80
(20)	Call Forwarding - Station user may temporarily reroute his calls to the attendant, another system station or either a local or toll number, each line	$ 11.00	$ 3.10
(21)	Message Detail Recording - Provides a record of FX, WATS, Tie Trunks, CCSA and DDD calls (does not include processing), each system	$165.00	$277.95

S12.2 Centrex Service

S12.2.9 Rates

d. Schedule of Rates

		Monthly Rates For Network Access*	Monthly Rates For Inter-Communication
(1)	Centrex CU Main or Administrative Centrex lines		
	First 200 lines, each	$33.60	$6.20
	Next 400 lines, each	17.15	8.15
	Next 400 lines, each	11.95	6.90
	Over 1,000 lines, each	10.95	4.15

S12. ETSX AND CENTREX SERVICE

S12.2 Centrex Service

S12.2.9 Rates (continued)

	For Network Access*	Monthly Rates For Inter-Communication
(2) Centrex CO Main or Administrative Centrex lines		
First 200 lines, each	$33.60	$6.70
Next 400 lines, each	17.15	8.80
Next 400 lines, each	11.95	7.60
Over 1,000 lines, each	10.95	4.80
Restricted lines, each		$3.50

Note: Centrex is offered only as a complete service. The Network Access and inter-communication portions of the above Centrex rates are not offered separately and neither is applicable in conjunction with customer-provided facilities.

* The Network Access monthly rate applies in addition to the Common Access Line Charge (CALC) shown in Tariff P.S.C. Ky. No. 6.

S12.2.10 Centrex Restricted Lines

	Monthly Rate
a. CU Restricted Key System Main Line	$3.50
b. CU Restricted Station Line	3.50
C. Key Extension Key In Lieu	1.10

S13. MISCELLANEOUS SERVICE ARRANGEMENTS

S13.2 Extension Service Mileage Charges

S13.2.1 General

d. Extension service lines between locations within the same exchange are subject to an extension line mileage charge of $3.91 per month for each quarter-mile (1,320 feet) or fraction thereof circuit measurement (MI OX 1/4).

f. DELETED

S13. MISCELLANEOUS SERVICE ARRANGEMENTS

S13.2 Extension Service Mileage Charges

S13.3.2 Rates and Charges

The following rates apply to any network access line (including PBX services) providing Touch Calling Service:

	Monthly Rate
Residence, per line*	$1.45
Business, per line*	2.55

* On a two, four or eight-party line, rates shown are applicable per customer.

The above rates are in addition to service charges, monthly rates and any other applicable charges for the service with which the lines are used.

The Central Office Line Connection Charge does not apply when service is changed from rotary dial operation to touch calling operation.

S13.4 Smart Call^sm Services

e. Toll Denial

S13.4.2 Provision of Service

a. The services are limited to those areas served by central offices arranged for Smart Call^sm Services.

S13.4.3 Rates and Charges

a. Single Feature - One Smart Call^sm feature per line

	Monthly Rate	
Features	Residence	Business
(1) Call Waiting, per line	$3.70	$5.50
(2) Call Forwarding, per line	2.00	3.50
(3) Three-Way Calling, per line	3.75	5.00
(4) 8-Number Speed Calling, per line	2.20	2.75

S13. MISCELLANEOUS SERVICE ARRANGEMENTS

S13.4 Smart Call[SM] Services

S13.4.3 Rates and Charges (continued)

		Monthly Rate	
		Residence	Business
(5)	30-Number Speed Calling, per line	$3.50	$5.00
(6)	Toll Denial, per line	2.75	4.75

b. Package - Smart Call[SM] features on same line

		Residence	Business
(1)	Call Waiting, Call Forwarding, Three-Way Calling, and 8-Number Speed Calling, per line	$5.50	$7.50
(2)	Call Waiting and Call Forwarding, per line	4.25	6.25
(3)	Call Waiting, Call Forwarding, and Toll Denial, per line	4.75	6.75

c. Service charges are not applicable when Smart Call[SM] Service features are provided at the same time as the business or residence individual line service is established.

d. When features are added or rearranged on an existing line, the Network Access Change charge as shown in Section 4 will apply. (Note: Central Office Line Connection Work charge does not apply when features are added or rearranged).

S20. PRIVATE LINE SERVICE AND CHANNELS

S20.2 Intraexchange Private Line Service

S20.2.1 Local Private Line Service

b. Rates (in addition to all applicable Service Charge)

	Monthly Rate
(1) Channels	
(a) Each quarter mile or fraction (airline measurement)	$3.91

S20. PRIVATE LINE SERVICE AND CHANNELS

S20.4 1.544 Megabit Service

S20.4.4 Rates and Charges

The rates below are for 1.544 Mbps service furnished for private line intraexchange communications. The minimum period for which service is furnished and for which charges are applicable is 12 months.

		Monthly	Installation
a.	1.544 Access Line		
	First Airline Mile	$200.00	$754.40
	Each Additional 1/4 Airline Mile or Fraction Thereof	30.00	
b.	1.544 Special Transport Each Airline Mile or Fraction Thereof	85.00	

(1) A move charge equal to 1/2 of the 1.544 Access Line installation charge will apply for each customer location within a wire center where the 1.544 Access Line is moved.

(2) The rates above include automatic failure protection on all equipment located on Company premises.

(3) In addition to the above rates, and charges, the Network Access Establishment and Premises Visit Charge applies as specified in Section S4 of this tariff for all requests for the same customer made at one time.

S113. DISCONTINUED MISCELLANEOUS SERVICE ARRANGEMENTS

S113.1 Custom Calling Services

Not offered for new installations, moves or rearrangements on or after the effective date of this tariff. Refer to Section S13 for rules, regulations and definitions.

c. Package Feature

Allows for two or more custom calling features on the same line except that rates shown below apply only for package combinations not included in Section S13.4.3.b.

S113. DISCONTINUED MISCELLANEOUS SERVICE ARRANGEMENTS

S113.1 Custom Calling Services (continued)

d. Rates

Package - two or more custom calling features on the same line.

		Residence	Business
(1)	Call Forwarding, per line	$1.30	$3.10
(2)	Call Waiting, per line	2.40	4.75
(3)	Three-Way Calling, per line	2.55	3.90
(4)	8-Number Speed Calling, per line	1.30	2.25
(5)	30-Number Speed Calling, per line	1.70	3.10

S120. DISCONTINUED TIE LINE MILEAGE

S120.1 Tie Line Mileage Charges

These rates apply to existing customers only.

	Monthly Rate
Each quarter mile or fraction thereof, circuit measurement between switchboards	$3.91

The minimum charge for each tie line is $3.91 per month.

Note: 4-wire circuits are double the rate shown above.