

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION INTO DIVERSIFIED)
OPERATIONS OF LOCAL EXCHANGE) ADMINISTRATIVE
TELEPHONE COMPANIES) CASE NO. 340

O R D E R

BACKGROUND

On October 25, 1991, the Commission, on its own motion, initiated this investigation to ensure that recent ventures by local exchange companies ("LECs") into diversified activities were not being subsidized by subscribers of monopoly services. In particular, the Commission was interested in LEC-related cellular activities. Included in the Order was a series of questions directed toward gathering information which would allow the Commission to better understand the LECs' involvement in cellular operations. Responses were due November 25, 1991. After several motions for extensions of time were received, the response deadline was extended to January 1, 1992. After reviewing the responses, a second information request was issued on April 6, 1992. The questions included in this Order, in general, were targeted to gathering specific information from individual companies. Responses were due on May 6, 1992. Following review of responses to the second information request, the issues were narrowed and an informal conference was scheduled by Order dated July 1, 1992, to discuss the remaining issues. The informal conference was set for July 10, 1992 and subsequently rescheduled for July 24, 1992, at

the request of the LECs. The Kentucky Telephone Association is an intervenor to the case.

INTRODUCTION

In 1989, the Federal Communications Commission ("FCC") established a lottery by which it awarded two licenses to provide cellular telephone service in specific geographical areas in rural America. These areas were called Rural Statistical Areas ("RSAs"). Within the RSAs, licenses were awarded to one wireline company and one non-wireline company. In Kentucky most of the small cooperative and investor-owned companies comprising the Independent Telephone Group ("ITG")¹ submitted applications to the FCC and several were successful. Those that were not successful eventually entered into investment arrangements whereby they participated in the operation of one or more cellular entities on some percentage basis. This investment for all of the participating companies approximated \$22 million. The largest of these investments was \$4.3 million and the smallest was \$.12 million. These investments were made possible through the accumulation of cash reserves which resulted from operating revenues exceeding operating expenses. According to the companies the decision to diversify was based upon

¹ Ballard Rural Telephone, Inc.; Brandenburg Telephone Company; Duo County Telephone Cooperative, Inc.; Foothills Rural Telephone Cooperative; Harold Telephone Company; Highland Telephone Cooperative, Inc.; Logan Telephone Cooperative, Inc.; Mountain Rural Telephone Cooperative; North Central Telephone Cooperative, Inc.; Peoples Rural Telephone Cooperative; South Central Rural Telephone Cooperative; Thacker-Grigsby Telephone Company; West Kentucky Rural Telephone Cooperative.

the belief that the companies would be providing a necessary telecommunications service to rural areas of the state.

This diversification into other areas causes the Commission some concerns. In particular, the Commission is concerned that it has not been informed of diversification before it occurs. Although in this case the RSAs were established by the FCC and there are accounting guidelines such as the cost allocation manuals which potentially mitigate against cross-subsidization, the Commission believes that diversification plans should be communicated prior to implementation. Also, the Commission is concerned that members of cooperatives may not realize the magnitude of diversification and that such activity is being financed with cash reserves which eventually would be returned to cooperative members in the form of capital credits. On the other hand, the Commission realizes that such investments are assets whose value should appreciate to the members' benefit if the LEC eventually disposes of its share of the cellular investment.

DISCUSSION

The issues discussed at the informal conference can be broken down into two general areas. The first set of issues is concerned with accounting safeguards to avoid the possibility of cross subsidies between the LEC and its cellular affiliates and the second with the potential liability of the LEC as a general partner of the cellular entity in which it has invested.

Accounting Issues

Responses to the Commission's two information requests revealed inconsistencies in recording cellular investments on the companies' records. The Uniform System of Accounts For Telecommunications Companies ("Part 32") does not provide guidance for all of the situations encountered in this case. Therefore, the companies mutually agreed that cellular investment would be recorded in Part 32, Account 1401, "Investments in Affiliated Companies." Also gains or loss attributable to the LEC's portion of the cellular affiliates operations shall either be debited (gain) or credited (loss) to the account with an offsetting entry to Account 7360, "Other Non-Operating Income." This is generally referred to as the "Equity Method" of accounting for investments in affiliated companies. This journalization will provide consistency among all of the LECs and allow the Commission to determine the extent of investment and results of operations of cellular activities attributable to each LEC.

Also inconsistent, albeit to a lesser extent, was the recording of revenues derived by the LECs from the leasing of central office and tower space to the cellular affiliate. After some discussion, the parties agreed that revenues derived from leases such as those previously mentioned should be journalized to Part 32, Account 5240, "Rent Revenues." This is consistent with Part 32 as well as the historical treatment of such revenues. Revenues derived from interconnection of the cellular company to the local network as well as special facilities revenues will be

recorded to the accounts associated with the tariff from which the rates are derived. For example, if interconnection rates are taken from access tariffs, revenues shall be recorded in Account 5084, "State Access Revenue." The concern in addressing this issue was that revenues derived by the LECs as the result of cellular interconnection would be recorded in non-regulated revenue accounts.

Also at issue was the possibility of the use of LEC billing equipment for cellular billing and the concern that the cellular company was being billed compensatory rates. As a result of the discussion, it was established that none of the LECs were engaged in billing for cellular operations.

In its information requests the Commission attempted to get a clear understanding of how each LEC was handling any billing to cellular companies as a result of services performed for cellular operations by LEC employees. Although the cost allocation manuals approved in Administrative Case No. 321² addressed the issue of allocation of costs to non-regulated activities, the case did not specifically address the allocation of costs to another regulated entity. Thacker-Grigsby and Harold telephone companies, which are managing partners of the cellular operations of which they are a part, described their procedures in detail. The remaining companies, which are passive investors rather than managing partners, provided a variety of answers, pointing out that such

² Administrative Case No. 321, Separation of Costs of Regulated Telephone Service From Costs of Non-Regulated Activities.

activity was de minimus. The Commission was unable to completely determine from the responses how these costs were being allocated. It was agreed that companies would provide detailed information as to how any common costs, no matter how de minimus, are charged to the cellular operations.

Liability Issue

The final issue discussed at the informal conference was the potential liability to which the LECs might be exposed as a result of their investment in cellular operations. All of the parties agreed that liability is limited to the LEC's investment, except where a general partnership arrangement is in force. General partnerships involve substantially more risk to the LEC than do other arrangements. The Commission recognizes that there may be reasons, such as tax consequences, which would persuade a company to enter into a general partnership agreement, however, specific reasons were not provided in all cases. The Commission would like to be apprised of these reasons. Further, the Commission would encourage LECs with general partnership investments to amend their arrangements to a subsidiary arrangement or, in the alternative, require them to provide the Commission with proof of adequate liability insurance. This proof should include the basis for the amount of coverage being carried.

Cooperative Disclosure

As mentioned in the introduction, the Commission is concerned that the extent of investment in cellular activities by each cooperative may not be readily known by its membership. The

cooperatives have generally stated that their members have been made aware of their investment in cellular activities. However, the Commission wishes to ensure that cooperative members have ongoing information regarding the extent of their cooperative's investments in cellular telephone businesses. Therefore, the Commission has determined that specific disclosure is in the public interest and shall require each cooperative with either direct or indirect cellular investment to prepare a bill insert, to be sent to each cooperative member, reflecting the approximate cellular investment to the point in time that the insert is mailed. Subsequently, but no less than annually, each company will inform each of its members, either through a bill insert or notification in the cooperative's newsletter (should one exist) of the additional investment since the previous notification. The Commission also encourages the cooperatives to disclose to members all other relevant information about cellular investments, including annual profits or losses. Each cooperative shall notify the Commission as to the method to be used for notification.

Having considered the evidence and being sufficiently advised, the Commission HEREBY ORDERS that:

1. Cellular investment shall be recorded in Account 1401, "Investments in Affiliated Companies" and gains and losses shall be either deleted or credited to this account with a contra entry to Account 7360, "Other Nonoperating Income."

2. Revenues derived from leases between the LEC and cellular company shall be recorded to Account 5240, Rent Revenues.

Interconnection and special facilities revenues shall be recorded according to which tariff the rates are taken from.

3. A copy of all lease agreements and interconnection or special facilities contracts shall be filed with the Commission within 60 days of the date of this Order.

4. Subsequent changes to such agreements or contracts shall be filed by letter with the Commission referencing the above-styled case, within 30 days of signing.

5. All companies shall file with the Commission details showing how billings are made to cellular affiliates for time provided to the cellular affiliates by telephone company employees, officers, directors, etc. within 60 days of the date of this Order.

6. All LECs affiliated with cellular operations in a general partnership arrangement shall file proof of adequate liability insurance and the basis upon which the liability limits were established within 60 days of the date of this Order.

7. Reasons for entering into general partnership agreements as opposed to subsidiary or limited partnership agreements shall be filed within 60 days of the date of this Order.

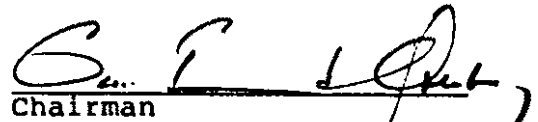
8. Each cooperative with cellular investments, either through an affiliated company arrangement or through partnership agreements, shall within 60 days of the date of this Order inform each individual member of its approximate investment to date in cellular operations through a bill insert, and shall provide a copy of the bill insert to the Commission.

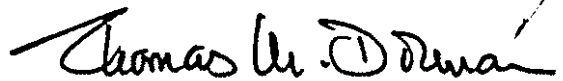
9. Subsequent notification to each member shall be made no less than annually from the date of the initial notification.

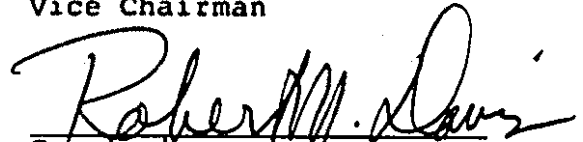
10. Each cooperative subject to ordering paragraph number 9 shall inform the Commission of the methodology to be used in the annual notification process. A copy of the first annual notification shall be forwarded to the Commission coincident with membership notification.

Done at Frankfort, Kentucky, this 21st day of September, 1992.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director