COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF RATES OF THE SALEM TELEPHONE COMPANY, INC.	)	CASE NO. 91-217

O R D E R

On July 26, 1991, Salem Telephone Company, Inc. ("Salem") filed an application to increase its local rates by $165,620. On February 28, 1992, the Commission issued an Order granting no increase and finding that Salem had excess revenues of $70,332. On March 18, 1992, Salem filed for rehearing on several issues, but its motion was granted only on the issue of corporate allocations. The rehearing was held September 9, 1992.

The Commission's findings and decisions upon reconsideration of Salem's corporate allocation expense and the attendant rehearing rate case expense are as follows:

Corporate Allocations

As a member of the TDS system, Salem is the recipient of directly assigned charges and an allocation of the corporate overheads of its parent and other senior affiliates.

Total TDS allocations from six affiliated companies to Salem in the test year (April 1990 - March 1991) were $216,446. After consideration of capitalizations, non-regulated items, and adjustments, Salem's total proposed cost-of-service recovery was $184,523. In its February 28, 1992 final Order, the Commission approved $24,438 of the corporate allocations for justified accounting and billing allocations. The Commission disallowed the remainder because Salem had failed to demonstrate, prove, and quantify specific benefits as a result of the corporate charges.

Salem is a wholly owned subsidiary of TDS Telecom, which is the telephone business segment of Telephone and Data Systems, Inc. ("TDS"). Salem is one of three telephone companies owned by TDS in the Commonwealth of Kentucky, along with Lewisport Telephone Company, Inc. ("Lewisport") and Leslie County Telephone Company, Inc. ("Leslie County"). The three Kentucky companies are a component of the Southeast Region of TDS headquartered in Knoxville, Tennessee.

In the February 28, 1992 Order, Salem was put on notice that:

> "[i]n order to include affiliate charges in cost of service, Salem and TDS have the burden of proving, demonstrating, and quantifying the specific benefit accruing to Salem's ratepayers as a result of each corporate charge."[1]

This notice followed an in-depth discussion of the Commission's concern and its efforts to ascertain quantifiable benefits flowing directly to Salem and its ratepayers.

Moreover, in its Order, the Commission cautioned Salem that it would be required to meet <u>each</u> of the following criteria, and,

> "[s]hould be prepared, through competent material documentation, to demonstrate that each affiliate charge: 1) is related to a service that is reasonably necessary for the provisioning of telecommunications service to its ratepayers; 2) is not duplicative of services available through its local

[1] February 28, 1992 Order, page 10.

> workforce or resources; 3) is not duplicative of services rendered by other affiliates; 4) produces a tangible benefit to the ratepayers; and 5) is at or below the fair market value of the service provided."[2]

Salem undertook to address the above criteria directly by conducting a Value of Service Study ("VOS Study"). This study first categorized the corporate allocations into 170 distinct functions. Then a questionnaire directly addressing each criterion was completed by a TDS employee closely engaged in each of these functions. Lastly, outside vendors were contacted with the objective of establishing the cost of obtaining each function on an out-source basis. The completed questionnaires and outside vendor estimates were then reviewed by an independent CPA firm, Kiesling Associates, for an opinion regarding functions that did not meet the Commission justification criteria. Kiesling Associates' report recommended the disallowance of $8,779 relating to functions that did not meet the justification criteria.[3]

The final VOS Study consisted of approximately 700 pages of primary and summary data addressing the test-year TDS corporate allocations. Although the Commission finds this method generally responsive to the required justification criteria, the VOS Study failed to demonstrate that the corporate allocations produce a tangible benefit to the ratepayers. Therefore, the Commission

---

2 Id., pages 10-11.

3 Kiesling Associates' Report on Value of Service Study, page 15.

affirms its February 28, 1992 decision as it relates to corporate allocations.

As demonstrated by its questioning throughout this proceeding, the Commission's primary concern is the specific current tangible benefit accruing to the typical Salem ratepayer from the TDS service costs he or she is being asked to bear. The burden for establishing this benefit was placed on TDS and Salem in the fourth criterion of the February 28, 1992 Order.[4] To satisfy this criterion, the Commission finds there must be a current, specific, clearly identifiable improvement in day-to-day services which tangibly manifests itself to the Salem customer. In examining the portions of the VOS study where the alleged benefits to Salem customers are set forth (item 4 of the questionnaires), the Commission finds that Salem and TDS have not satisfied this criterion.

With the exception of improvements in accounting and billing, the costs of which have already been approved, the benefits identified are generally of a non-tangible, non-current nature and outside the scope of the standard for meeting the established criterion. The "benefits" described pertain more to corporate overhead than to customer service. The Commission finds that Salem has failed to set forth specific benefits derived by Salem customers.

---

[4] February 28, 1992 Order, page 11.

In addition to the tangible benefit criterion, four other criteria were set forth in the February 28 Order. While the primary reason for the Commission's affirmation of its February 28 Order is Salem's failure to show a tangible benefit flowing from the corporate allocations, the Commission also has serious concerns relating to the other four criteria.

Criterion 1 required a showing that the affiliate charge is related to service that is reasonably necessary to provide telecommunications service to its ratepayers. This criterion was addressed in item 3 of the VOS Study questionnaires. Many of the responses pertained to the activities necessary to sustain TDS as a national telecommunications business rather than activities necessary to providing telephone service in Salem, Kentucky and are therefore outside the scope of this criterion. However, as previously noted, no specific disallowances have been made on this basis.

Criteria 2 and 3 pertain to duplication. This issue is addressed in item 5 of the 170 questionnaires and some 75 of the responses from TDS employees admitted that some degree of duplication exists. Additionally, many of the replies which stated that there was no duplication were qualified. The Commission recognizes that in any organization vertical and horizontal duplication may be inevitable. However, many companies do not aggressively address the problem of existing duplication unless there is a significant incentive to do so. While the responses to the questionnaire, Item 5, suggest that TDS may have undesired duplication, the Commission has not made specific disallowances on this basis.

Criterion 5 required TDS to show that the services charged to Salem were at or below their fair market value. The VOS study, as submitted, alleged that test-year charges were approximately $60,000 less than fair market value. The allocated cost of only a few isolated functions were identified as being above their fair market value. The Commission's main concern with TDS' response to this criterion is the method used to price outside services. To obtain prices for outside vendor services, TDS contacted persons with whom it had had a previous business relationship and informed them that they needed price data for a Kentucky rate case. The "outside vendor price" was in no way based on competitive bidding and has very little credibility as a true market price of out-sourced services. Nonetheless, the Commission has not made specific disallowances on this basis.

The response to Item 1 of the August 14, 1992 Order illustrates Salem's failure to meet its burden. There, the Commission set forth nine categories, six of which (Items (a) through (f)), illustrate uncontrovertible tangible benefit items. The remaining categories were "other tangible benefits," "intangible benefits," and "other." The Commission asked Salem to categorize its affiliate charges to the extent that they fit into those categories. Of the charges not excluded by Kiesling Associates or previously accepted, very few were allocated by Salem to categories (a) through (f). Rather, Salem chose to categorize the items as "other tangible benefits," which it then separated into subcategories G-1 through G-6. The Commission finds these items, as set forth by Salem, do not constitute tangible benefits as contemplated under criterion 4 of the February 28, 1992 Order. Subcategories G-1 through G-6 as set forth by Salem describe nebulous non-current and potential benefits, the cost of which should not be borne by Salem ratepayers. While there were isolated instances in which particular functions were allocated to the Commission's tangible benefit categories A-F, the associated costs were immaterial and do not persuade the Commission to overturn its Order of February 28, 1992.

Double-Eliminated Expense

In its February 28 Order, the Commission eliminated $12,815 of inappropriate cost-of-service items twice. As a result, the Commission has increased Salem's revenue requirement by $12,815 to correct for this double elimination.

Rate Case Expense

Upon rehearing, Salem incurred additional rate case expense of $96,100, $89,885 of which was associated with the cost of preparing the VOS study. Salem also identified $9,981 in previously unrecognized expenses associated with "original" rate case expenses incurred prior to the issuance of the February 28 final Order. Salem proposes to recover all of these expenses through a three-year amortization period.

The Commission will allow the $96,100 in rehearing costs amortized over three years. However, the Commission finds that the

$9,981 associated with pre-rehearing costs should be denied on the basis that original rate case expense was not an issue on rehearing.

Amortization of the allowed rehearing expense produces an additional revenue requirement of $32,033.

REVENUE REQUIREMENTS

Based on the foregoing, the Commission finds that, upon rehearing, Salem's revenue sufficiency as previously determined in the February 28, 1992 Order should be reduced by $44,848, from $70,332 to $25,484, to reflect the additional expenses recognized herein.

SUMMARY

The Commission, being otherwise sufficiently advised, HEREBY ORDERS that:

1. The corporate allocation expense requested by Salem is hereby denied with the exception of an additional $12,815 in revenue requirement related to double counting, and the Commission's decisions relating to corporate allocations as set forth in its February 28, 1992 Order are otherwise affirmed.

2. The rate case expense associated with the rehearing is hereby approved on an amortized basis over three years.

Done at Frankfort, Kentucky, this 19th day of January, 1993.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Don Mills

Executive Director