

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION INTO THE REASONABLENESS)
OF THE EARNINGS OF BRANDENBURG TELEPHONE) CASE NO. 92-563
COMPANY, INC.)

O R D E R

On January 11, 1993, the Commission ordered Brandenburg Telephone Company, Inc. ("Brandenburg") to file comments stating the reasons why it should not lower its rates to earn no more than its authorized rate of return of 12.5 percent on equity capital and 10.08 percent on net investment. On May 4, 1993, the Commission ordered Brandenburg to respond to Commission data request items related to Brandenburg's comments which were filed March 31, 1993. Brandenburg's responses were filed July 7, 1993.

Accordingly, the Commission finds the following are issues to be resolved in this proceeding:

1. Whether it is appropriate to recognize some revenue growth to bring test year revenues to an end of period level, given that local service and access revenues have increased every year during the period 1989 through 1992 and for the first quarter of 1993 annualized.

2. Whether concession service should be borne by the stockholders and not the ratepayers of Brandenburg and whether the concession service should be imputed to local service revenues to recognize that it is the stockholders' responsibility.

3. Whether advertising expenditures of Brandenburg conform to the requirements set forth in 807 KAR 5:016 which outlines the criteria for including advertising expenditures in rates.

4. Whether director's fees paid to officers of Brandenburg who also draw salaries should be disallowed in determining rates.

5. Whether legal and accounting expenses associated with rate case proceedings should be amortized over a time frame which approximates the interval between rate investigations.

6. Whether non-recurring, one time expenditures should be considered in setting rates.

7. Whether Brandenburg's pro forma wage increase of \$297,914 effective October 28, 1992 is reasonable. Specifically, whether this wage increase of approximately 10.3 percent is reasonable given a Value Line estimate that the average compensation per hour for non-farm labor would increase 4.26 percent for the period 1993-1997. (March 26, 1993 Exhibit by Value Line at p. 9489.)

8. Whether speculative additions to telephone plant should be included in Brandenburg's rate base at this time.

9. The anticipated construction time table for a new central office.

10. Whether investments made in rural telephone bank stock are sufficiently related to the provision of Brandenburg's service to subscribers to be included in the rate base.

11. Whether it is reasonable to average "material and supplies" and "prepaids" included in the net investment rate base to recognize monthly fluctuations in these accounts and thereby

avoid including an amount that may not be representative of Brandenburg's average investment during the test period.

12. The appropriate rate changes to implement any revenue adjustments ordered by the Commission.

13. The appropriate capital structure and cost of individual components including long-term debt, short-term debt, and the cost of equity.

14. Whether Brandenburg's capital components should vary significantly from the industry averages as found in an article of the April 1993 edition of Value Line which charted the composite capital structure for the telecommunications industry for 1989 through 1998, showing that the equity component was 45 percent for 1992 and estimated it to be 44 percent for 1993, 43.5 percent for 1994, and 39.5 percent for the period to 1998. Brandenburg's Form T for 1992 reflects a capital structure consisting of approximately 71 percent equity and 29 percent debt.

15. Whether this Commission could reasonably implement reductions for Brandenburg similar to those discussed in a management audit report and Pennsylvania Public Utility Commission ("PPUC") Order for a telephone company in Pennsylvania, North Pittsburgh Telephone Company. A copy of the relevant portions of the management audit report and PPUC Order are attached hereto and incorporated herein.¹

¹ A copy of the entire management audit report is available for inspection at the Kentucky Public Service Commission's offices.

IT IS THEREFORE ORDERED that:

1. Brandenburg shall, within 20 days from the date of this Order, provide the names and qualifications of witnesses to address each of the issues enumerated above.

2. Brandenburg shall appear at a hearing scheduled on September 29, 1993, at 10:00 a.m., Eastern Daylight Time, in Hearing Room 1 of the Commission's offices at 730 Schenkel Lane, Frankfort, Kentucky.

3. Brandenburg shall give notice of the hearing in accordance with the provisions set out in 807 KAR 5:011, Section 8(5).

4. Any request for an informal conference shall be made in writing and filed within 20 days of the date of this Order.

5. Any request to reschedule the hearing is to be made in writing and filed at least two business days prior to the date of the scheduled hearing.

Done at Frankfort, Kentucky, this 18th day of August, 1993.

PUBLIC SERVICE COMMISSION



For the Commission

ATTEST:



Executive Director

**DOCUMENT
FOLDER**

**PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265**

Public Meeting held December 19, 1991

Commissioners Present:

William H. Smith, Chairman
Joseph Rhodes, Jr., Vice Chairman
Wendell Holland
David W. Rolka

**DOCKETED
JAN 07 1992**

Petition of North Pittsburgh Telephone Company, Office of Consumer Advocate and AT&T Communications of Pennsylvania, Inc., Requesting Special Permission to File Tariff Supplements For Rate Reduction on Less than Statutory Notice

R-912138

OPINION & ORDER

BY THE COMMISSION:

Part I - Matter Before The Commission

On November 15, 1991, North Pittsburgh Telephone Company ("North Pittsburgh" or "Company"), the Office of Consumer Advocate ("OCA") and AT&T Communications of Pennsylvania ("AT&T"), hereinafter referred to as "Joint Petitioners", filed a Joint Petition for Rate Reduction requesting special permission for North Pittsburgh Telephone Company to file, or cause to be filed, tariff supplements to North Pittsburgh's Local Tariff-Telephone Pa. P.U.C. No. 11, the Pennsylvania Telephone Association's Toll Tariff-Telephone Pa. P.U.C. No. 10, and the Pennsylvania Telephone Association's Access Tariff-Telephone Pa. P.U.C. No. 9, providing for rate reductions resulting in a net annual revenue decrease of approximately \$1,447,000, to become effective on less than statutory notice, on January 1, 1992. On November 22, 1991, the Office of Small Business Advocate filed a Statement In Support of Joint Petition For Rate Reduction.

Under the Joint Petition, all customer classes will receive substantial rate decreases resulting in approximately the same percent reduction in revenue (about 9.5%) which will enable all customers to benefit uniformly from the proposed revenue reduction. A breakdown of the change in annual revenue by service classification is summarized below:

| | CHANGE IN ANNUAL REVENUE | % Decrease |
|-----------------------------------|-----------------------------|---------------|
| <u>LOCAL SERVICE:</u> | | |
| Residence: | | |
| Basic Dial Tone Line | (\$209,464) | |
| Custom Calling | (\$99,798) | |
| | ----- | |
| Res. Subtotal | <u>(\$309,262)</u> | 9.38% |
| Business: | | |
| Basic Dial Tone Line | (\$131,380) | |
| Custom Calling | (\$25,050) | |
| | ----- | |
| Bus. Subtotal | <u>(\$156,430)</u> | 9.28% |
| Total - Local | <u>(\$465,692)</u> | |
| <u>TOLL SERVICE:</u> | | |
| Total - IntraLATA Toll Service | (\$155,694) | 1.81% |
| <u>ACCESS SERVICE:</u> | | |
| IntraLATA CCLC | (\$575,288) | 9.55% |
| InterLATA CCLC | (\$250,600) | 9.64% |
| | ----- | |
| Total - Access | <u>(\$825,888)</u> | |
| GRAND TOTAL RATE REDUCTION | <u>(\$1,447,274)</u> | |

The Joint Petition includes a stay-out provision whereby North Pittsburgh will not file a general rate increase for a two year period, prior to January 1, 1994, with the exception of any future proceedings which would result in mandatory rate changes due to legislative, regulatory, tax or accounting changes not already implemented as of the date of the filing of the Joint Petition.

In addition, AT&T has agreed in the Joint Petition to offer its Reach Out Pennsylvania interLATA toll discount service to North Pittsburgh's subscribers on the condition that the proposed interLATA Carrier Common Line Charge is approved on a "per access line per month basis".

We are in agreement with the Joint Petitioner's and the Office of Small Business Advocate's comments that the proposed Joint Petition will save the utility (and ultimately its customers) as well as the Commission and the public advocates the considerable expense that would be involved in litigation over the reasonableness of North Pittsburgh's current rates. The methodology of reducing rates, as proposed in the Joint Petition, is in accordance with our reasoning that all classes of customers should benefit uniformly from the proposed revenue reduction. Therefore, we shall grant the proposed Joint Petition to the extent contained in the body of this Opinion and Order.

PART II - DISCUSSION

A. BACKGROUND

North Pittsburgh Telephone Company's last general rate increase became effective October 1, 1969. Since that time subscriber growth and declining capital costs have benefitted the Company's earnings. The OCA became concerned that North Pittsburgh has been experiencing earnings which exceeded a reasonable rate of return on common equity. In order to avoid costly litigation, the OCA and AT&T approached North Pittsburgh for the purpose of amicably negotiating the terms and conditions for a voluntary rate reduction for North Pittsburgh Telephone Company's customers.

B. TERMS AND CONDITIONS OF JOINT SETTLEMENT PETITION

The Joint Petitioners are requesting that the Commission approve and adopt the terms and conditions of the proposed Joint Petition seeking annual intrastate rate reductions in the amount of \$1,447,273, without modification. Specifically, the Joint Petitioners are requesting approval of the following terms and conditions:

1. Grant permission for the filing of the following tariff supplements:
 - (a) A Local Service Tariff Supplement to North Pittsburgh's Local Tariff-Telephone Pa. P.U.C. No. 11, as contained in Appendix A of the Joint Petition, which contains rate reductions for:
 - (1) business and residence basic monthly local service rates; and,

- (2) various optional custom calling service rates (Call Waiting, Call Forwarding, 3-Way Calling, Speed Calling and Identical Ring Services).

These proposed rate reductions will result in annual local revenue reductions of \$340,844 and \$124,848, respectively, for a total annual local service revenue reduction of \$465,692.

- (b) A Toll Tariff Supplement to the Pennsylvania Telephone Association's Toll Tariff-Telephone Pa. P.U.C. No. 10, as contained in Appendix B of the Joint Petition, which contains rate reductions to North Pittsburgh's intralATA toll rates, resulting in an annual toll revenue reduction of \$155,694.

- (c) An Access Charge tariff supplement to the Pennsylvania Telephone Association's Access Tariff-Telephone Pa. P.U.C. No. 9, as contained in Appendix C of the Joint Petition, which contains rate reductions for the IntralATA and InterLATA Carrier Common Line Charge ("CCLC") for local exchange companies and interexchange companies, respectively, resulting in an annual access revenue reduction of \$825,888. In addition, the InterLATA CCLC will be modified to apply from a "per minute of use" basis to a "per access line per month" basis, whereupon AT&T also agrees to offer its Reach Out Pennsylvania discounted interLATA toll plan to North Pittsburgh's customers.

2. If the terms of the Joint Petition are approved, North Pittsburgh will not file a general rate increase prior to January 1, 1994. The Company also will not seek any increases in its interLATA access rates or basic local exchange service rates prior to January 1, 1994, with the exception of any future proceedings resulting in mandatory rate changes resulting from legislative, regulatory, tax or accounting changes not already implemented as of the date of the filing of the Joint Petition. Also, the OCA and AT&T agree not to initiate a proceeding against North Pittsburgh prior to January 1, 1994.

3. North Pittsburgh requests that the Commission state in any order approving this Joint Settlement that the Commission will not initiate a proceeding prior to January 1, 1994 which seeks a reduction in North Pittsburgh's jurisdictional rates.

In addition to the above terms and conditions, the Joint Petitioners have included the following standardized verbiage in the Joint Petition:

This Petition is conditioned upon the Commission's approval without modification or amendment. The Joint Petitioners agree that this Agreement shall have no force or effect unless accepted and adopted in its entirety by the Commission, except that this paragraph shall be effective regardless of whether the Petition is approved and adopted by the Commission. Any party may withdraw from this Petition if the Commission does not approve all of the terms and conditions thereof. If the Commission disapproves any portion of the Petition or modifies any term or provision thereof, a Petitioner, in order to withdraw from the Agreement, must file with the Commission, and serve upon all parties, a statement that such Petitioner is withdrawing from the Petition within five (5) business days after the Commission enters an order rejecting or modifying any term or condition thereof.

We believe that all of the above terms are reasonable, with the exception of the condition contained in Paragraph 3, above, which requests "that the Commission state in any order approving this settlement that the Commission will not initiate a proceeding prior to January 1, 1994, which seeks a reduction in the NPTC jurisdictional rates." In our opinion, it would be a dereliction of our statutory responsibility if we were to attempt to relinquish our authority to initiate a future proceeding against a jurisdictional telephone company. The granting of this request may cause future complications and make it difficult for the Commission to act on specific issues which may involve rate reductions for North Pittsburgh Telephone Company. Therefore, we shall grant all of the terms of the Joint Petition with the exception of the third request stated above.

C. PROPOSED RATE REDUCTIONS

A brief discussion of the proposed rate reductions we will allow for each service classification follows:

Local Service Rates

All residential and business customers will experience rate reductions in their monthly local dial tone line rates under the Joint Petition. All residential one-party rates will be reduced by \$0.50 per month and all business one-party rates will be reduced by \$1.00 per month. Rates for all other grades of service (i.e. residence and business Two-Party, Four-Party, Multi-Party, Rotary and PBX Trunks, Semi-Public and COCOT) will also be reduced by an amount in the range of \$0.20 to \$1.50 per month depending upon the service.

In addition, the Joint Petition calls for rate reductions for some of the optional custom calling services (i.e. Call Waiting, Call Forwarding, 3-Way Calling, Package Plan, 8-Code Speed Calling, 30 Code Speed Calling and Identia Ring Service ^{1/}). The Company is proposing that these services be decreased by 33% which will result in rate reductions ranging between \$1.00 to \$4.00 per month, depending upon the service.

We believe that the proposed reductions to local service rates are reasonable. It is hoped that the proposed rate reductions to the optional custom calling services will increase the penetration of subscribers to these custom calling services.

Message Toll Service Rates

The Joint Petition also contains revisions to North Pittsburgh's intralATA toll service rates. These revisions will result in rate increases and decreases in the toll rate mileage bands. These revisions were developed by reducing the Daytime additional minute rates by \$0.01 in the first two mileage rate bands, and altering the existing toll rate design so that the Evening and Night/Weekend rates will be listed as rates rounded to the nearest penny rather than basing them on a discounted percentage of Daytime toll rates as they are presently rated under the existing tariff. This alteration to toll rates will essentially maintain the existing 35% and 60%

^{1/} Identia Ring Service is presently offered on a non-tariffed trial service basis for North Pittsburgh's customers. The Company is establishing regulations associated with Identia Ring Service in this Petition and is proposing reduced rates for existing Identia Ring subscribers.

discounts for Evening and Night/Weekend rates, respectively. However, due to the rounding to the nearest penny, some rate mileage bands will have rates increased and some will have rates decreased by a fraction of a cent which will result in an overall annual revenue reduction of approximately \$155,694.

Access Charges

The Joint Petition also contains rate reductions to access charges so that interexchange carriers (i.e. AT&T, MCI, US Sprint, etc.) and local exchange telephone companies will also benefit from the North Pittsburgh's revenue reduction.

Specifically, the Joint Petition proposes reductions to the interLATA and intralATA Carrier Common Line Charges ("CCLC"). The intralATA CCL will be reduced from \$0.0471 per minute of use to \$0.0426 per minute of use. The interLATA CCL will be reduced and changed from a per minute of use basis to a flat rate per access line per month basis, from \$0.0471 per originating minute of use and \$0.0387 per terminating minute of use, to \$2.49 per access line per month.

Also, it is important to note that North Pittsburgh's customers will be able to save additionally on their interLATA toll calls since AT&T has agreed to offer its optional toll discount plan entitled "Reach Out Pennsylvania" upon approval of the interLATA CCLC reduction. We shall expect AT&T to file a tariff supplement which implements this agreement within ten (10) days of the date of entry of this Opinion and Order.

PART III - CONCLUSION

Our review and analysis of the Joint Petition indicate that it does not generally appear to be unjust, unreasonable, or contrary to the public interest. As a result, we shall grant the Joint Petition, to the extent contained in this Opinion and Order. However, this does not constitute a determination that the Joint Petition is reasonable or prudent for the purposes of determining just and reasonable rates in any future proceeding. Furthermore, the granting of this Joint Petition is hereby made subject to subsequent audit and review; THEREFORE,

IT IS ORDERED:

1. That the Joint Petition filed by North Pittsburgh Telephone Company, the Office of Consumer Advocate, and AT&T Communications of Pennsylvania, on November 15, 1991, providing for rate reductions resulting in an annual revenue

decrease of approximately \$1,447,000, to become effective on less than statutory notice, on January 1, 1992 be, and hereby is granted, in part, to the extent contained in the body of this Opinion and Order.

2. That within ten (10) days after the date of entry of this Opinion and Order, North Pittsburgh Telephone Company shall file, or cause to be filed, tariff supplements, in accordance with the Joint Petition, to become effective upon at least one day's notice.

3. That within ten (10) days after the date of entry of this Opinion and Order, AT&T Communications of Pennsylvania shall file a tariff supplement which extends its "Reach Out Pennsylvania" toll discount calling plan to North Pittsburgh Telephone Company's customers, to become effective upon at least one day's notice.

4. That a copy of this Opinion and Order be served upon North Pittsburgh Telephone Company, AT&T Communications of Pennsylvania, the Office of Consumer Advocate, and the Office of Small Business Advocate.

BY THE COMMISSION,


Jerry Rich
Secretary

(SEAL)

ORDER ADOPTED: December 19, 1991

ORDER ENTERED: December 20, 1991

**MANAGEMENT AND OPERATIONS STUDY OF
NORTH PITTSBURGH TELEPHONE COMPANY**

Pennsylvania Public Utility Commission

RECEIVED

JAN 31 1992

**P.S.C.
RESEARCH DIVISION**

MARCH 1989

**Scott Consulting Group
Raleigh • Houston • Atlanta**

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APPENDIX

VII - FINANCE

A - BACKGROUND AND PERSPECTIVE

Prior to 1978, NPTC's capitalization consisted of a minority interest (\$800,000 of 4 1/2 percent cumulative preferred stock issued in the late 1940's), common stock (none of which has been offered since 1968), and long-term debt that was furnished by Penn Mutual Life Insurance Company through a private placement. The Penn Mutual-furnished debt imposed covenants that restricted NPTC's financial flexibility and hampered the Company's ability to assume additional debt. As a result, the Company explored the possibility of securing Rural Electrification Administration (REA) financing. The Company was successful in obtaining a REA loan commitment through the Rural Telephone Bank and used it to replace the private placement through Penn Mutual. NPTC has relied exclusively on REA financing (and internally generated funds) ever since. The REA financing is at extremely advantageous interest rates -- 6 1/2 percent although Rural Telephone Bank investment requirements nudge the effective interest rate up to about 6.85 percent. It has enabled NPTC to completely modernize its entire telephone network. By 1987, NPTC exhausted the remaining unborrowed funds available to NPTC from the Rural Telephone Bank under currently approved loans. These funds were not fully required to fund NPTC's construction program because of positive cash flow resulting from strong earnings and changes (accelerations) in NPTC's depreciation practices. This aggressive use of long-term debt coupled with strong cash flow has created NPTC's holding of over \$13 million in marketable securities by the end of 1987.

The diagnostic review indicated that NPTC is earning actual rates of return on equity (25 to 30 percent) that far exceed those achieved by most of the telecommunications industry and rates that are much higher than those granted to other telecommunication carriers in recent rate cases. This range of rate of return numbers reflects total rate of return for both state and interstate operations. Allowed rates of return on equity in the 13.5 to 15.5 percent range have been typical in the last several years. Actual rates of return on equity often tend to be several percentage points lower. NPTC's profitability in part stems from the fact that its service territory is contiguous with important Pittsburgh commercial centers and hence the Company's business and residential customers have natural social and economic ties to Pittsburgh. Since none of the telephone calls placed from NPTC's service territory to Pittsburgh proper are local calls (except for those customers opting for NPTC's new circle calling plan), NPTC enjoys an unusually high proportion of toll revenue. In fact, toll revenue represents approximately 80 percent of NPTC's total revenue stream.

North Pittsburgh Systems, Inc. was organized as a holding company and merged with North Pittsburgh Telephone Company on May 31, 1985. The holding company was the surviving entity and NPTC became a wholly-owned subsidiary. In the merger, the common stock of NPTC (par value \$3.125 per share) was converted on a share for share basis into common stock (par value \$3.125 per share) of the holding company. NPSI stock was split 5-for-1 on December 11, 1986 and resulted in the current 3.76 million shares outstanding (par value \$.625 per share). While stock splits can effectively reduce the cost of acquiring a round lot (typically 100 or 500 shares) and therefore potentially attract smaller investors,

stock splits also tend to obfuscate earnings per share growth over an extended period of time. This is true of NPTC and NPSI earnings since the stock split. The holding company arrangement also no longer reveals stock ownership to the Pennsylvania Public Utility Commission. The Form M requires operating companies to list their top 30 shareholders. With the holding company structure, however, NPTC merely reports to the Commission that its shareholder is North Pittsburgh Systems, Inc. (100 percent ownership). In 1984 the top 30 shareholders held nearly 30 percent of the outstanding shares.

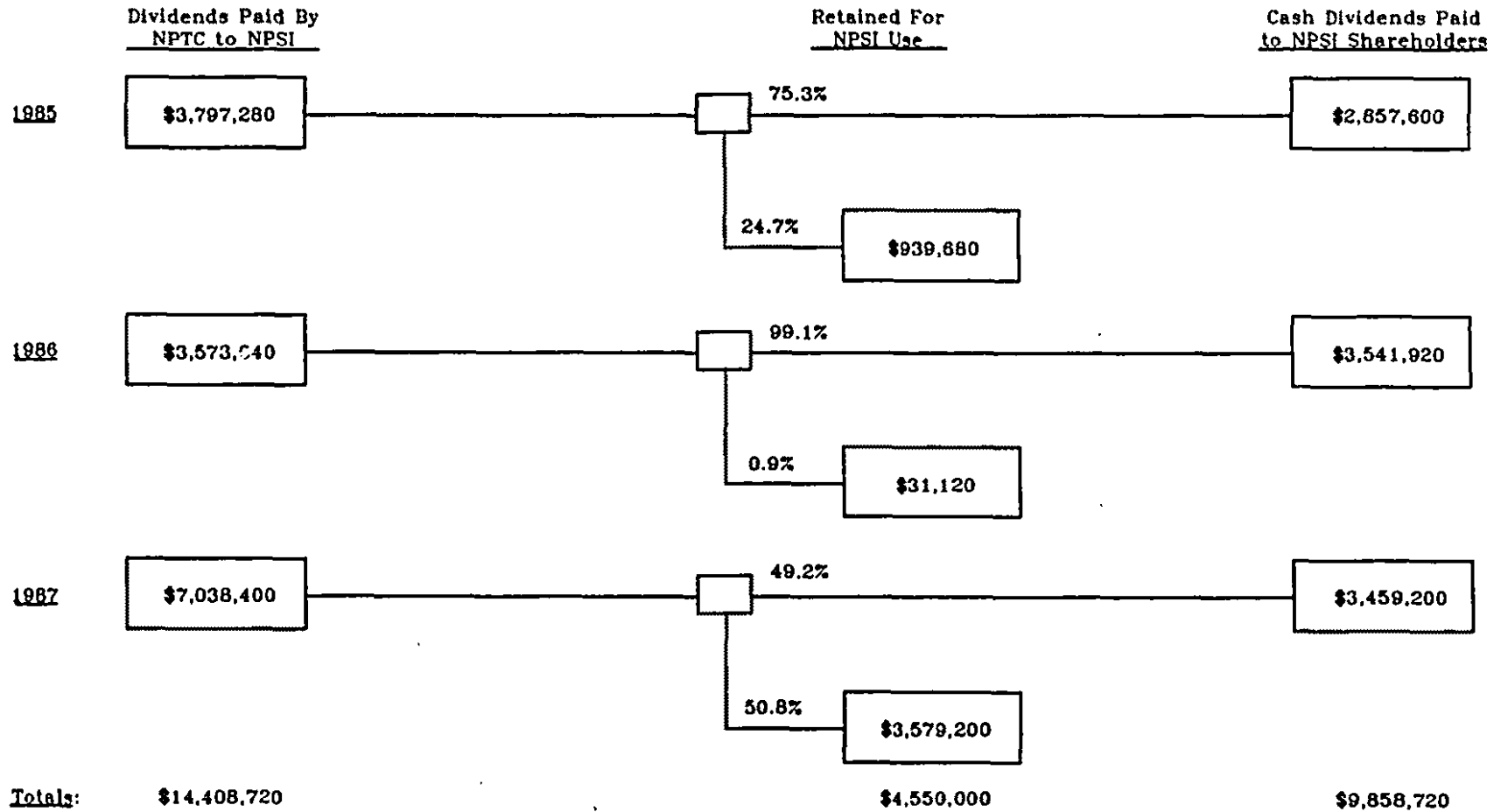
The creation of the holding company added separation between regulated and unregulated businesses. It also obscures the true profitability of NPTC. As a wholly-owned subsidiary of North Pittsburgh Systems, Inc., NPTC pays cash dividends to the holding company. The holding company (NPSI), in turn, pays cash dividends to the common shareholders. Not all of the cash dividends paid by NPTC to NPSI are passed on to the shareholders of NPSI. Exhibit VII-1 shows this process for the years that NPSI has been in existence (1985-1987). The net effect is to effectively transfer cash from the regulated entity (NPTC) to the unregulated entity (NPSI) and its unregulated wholly-owned subsidiary (PTI). This process has already transferred nearly \$5 million to NPSI in only three years. The determination as to whether or not any or all of these funds should have benefitted NPTC's ratepayers (which they didn't because of the transfer) or the NPSI shareholders (which they did) was beyond the scope of the diagnostic review.

The methodology used to conduct the diagnostic review of the NPTC financial function and practices is summarized below. It consisted of reviews of:

- NPTC's existing capital structure and the Company's choice of financial instruments (both debt and equity) in view of available alternatives. The relative conservativeness (or aggressiveness) of NPTC's financial strategy was also examined in light of NPTC's (and perhaps more subtly NPSI's) business strategy.
- NPTC's historical cash flow patterns and projected cash flows in light of planned capital expenditures. We reviewed NPTC's efforts and long-term plans to preserve ongoing access to both debt and equity capital.
- NPTC's internal financial controls both organizationally and procedurally.
- NPTC's management and control of working capital accounts such as accounts receivable, accounts payable, and materials and supplies.
- The operations of each of the groups within the NPTC finance organization: Cost Accounting, Treasury, General Accounting, Revenue Requirements, Data Information, and Payroll. Findings related to several of these groups are contained in Chapter VI.

PENNSYLVANIA PUBLIC UTILITY COMMISSION
 MANAGEMENT AND OPERATIONS STUDY OF
 NORTH PITTSBURGH TELEPHONE COMPANY

DIVIDENDS TO HOLDING COMPANY AND COMMON SHAREHOLDER



Sources: PAPUC Form M, 1987 North Pittsburgh Systems, Inc. Annual Report; SCG Analysis

B - FINDINGS AND CONCLUSIONS**(1) NPTC's Use Of Rural Electrification Administration Financing Is Appropriate And Should Be Continued**

The Rural Telephone Bank long-term financing has provided NPTC with a low-cost, secure source of debt financing. The 35 year notes (initially set to mature in 2013 but extended to 2019) have provided NPTC with the necessary funds and financial flexibility to completely modernize its telephone system. The embedded cost of this debt -- approximately 6.85 percent once the Rural Telephone Bank capital stock investment requirement is met -- is considerably lower than that faced by other telephone companies without access to REA financing.

Although NPTC has already exhausted (in 1987) its authorized loan commitment, the Company is attempting to preserve its access to REA financing. The REA has indicated that there are no impediments to NPTC's seeking additional loan commitments. In the interim, internally generated funds appear to be sufficient to satisfy all of NPTC's capital requirements for at least the next five years. As such, NPTC's external debt financing requirements over the reasonable financial planning horizon are minimal.

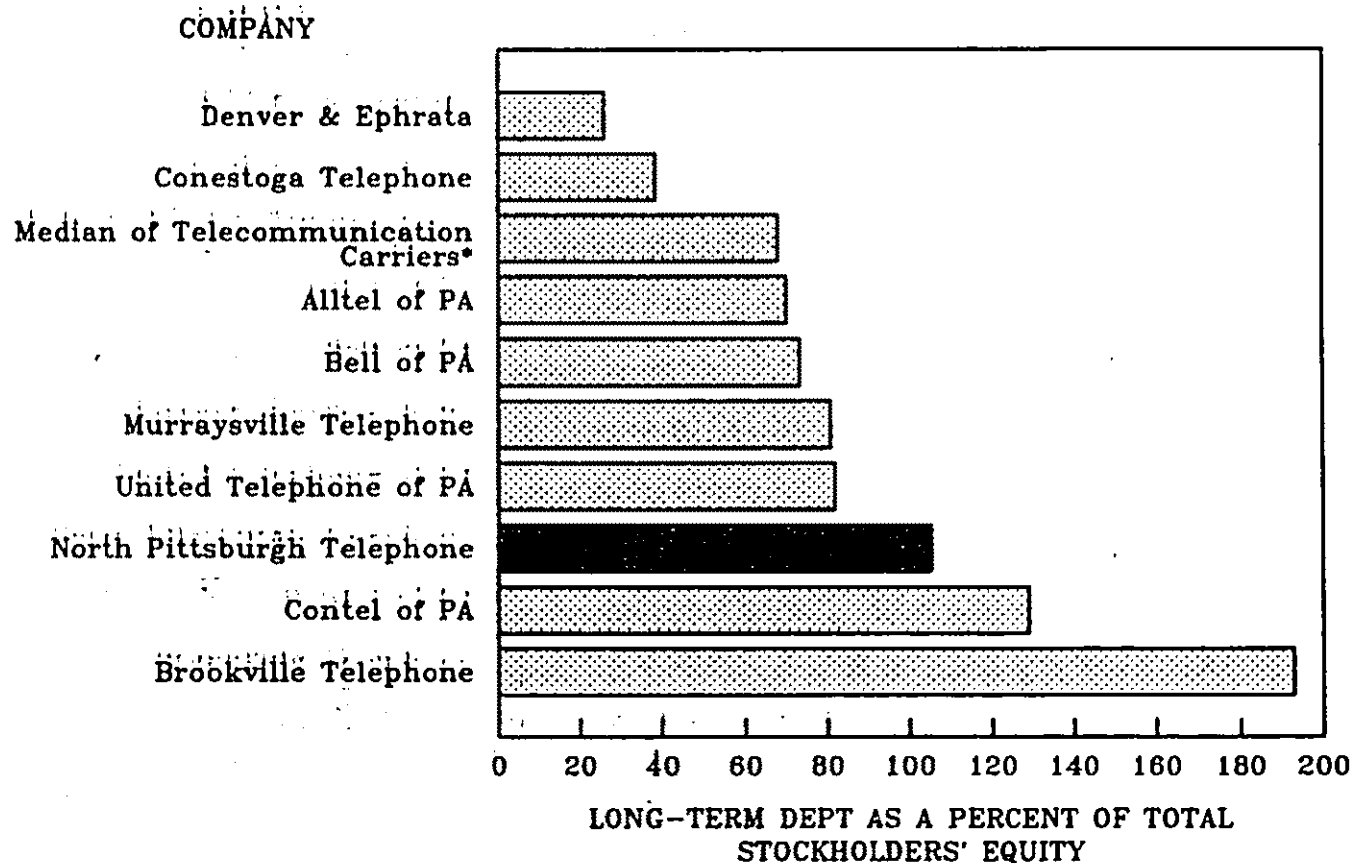
(2) NPTC's Capital Structure Is Not Conservative Relative To Its Peers

NPTC is more highly leveraged than the typical telecommunications carrier. Exhibit VII-2 shows the long-term debt to stockholders' equity (common and preferred) ratio of NPTC relative to a panel of eight other telephone companies with Pennsylvania operations. Only Brookville Telephone Company (193.0 percent) and Contel Telephone Company of Pennsylvania (129.2 percent) were more highly leveraged than North Pittsburgh Telephone Company (105.1 percent). Most of the other panel members -- Denver & Ephrata Telephone Company; Conestoga Telephone & Telegraph Company; Alltel Pennsylvania, Inc.; Bell of Pennsylvania; Murraysville Telephone Company and United Telephone of Pennsylvania had ratios of less than 80 percent. The median ratio of the entire telecommunication carrier industry is 68 percent.

Looking solely at NPTC's long-term debt to stockholders' equity ratio is somewhat deceptive in assessing its financial aggressiveness. The magnitude of marketable securities on NPTC's balance sheet tends to mitigate the potential risks associated with the Company's aggressive capital structure. These marketable securities could be used to extinguish a portion of NPTC's outstanding long-term debt and therefore bring NPTC's capital structure to a more conservative position. Nevertheless, on pure measures, NPTC is highly leveraged. Higher leverage always entails the assumption of greater financial risk in return for generally higher returns on equity. Whether or not this higher leverage makes sense given NPTC's fairly aggressive business strategy is also at question. Companies with aggressive business strategies often adopt relatively conservative financial strategies so as to provide assurance of long-term financial soundness. This is not of as much concern in NPTC's case because of its very large marketable securities holding.

PENNSYLVANIA PUBLIC UTILITY COMMISSION
 MANAGEMENT AND OPERATIONS STUDY OF
 NORTH PITTSBURGH TELEPHONE COMPANY

PANEL COMPARISON - FINANCIAL LEVERAGE



* Median reported in Forbes magazine report on Telecommunication Carriers, January 11, 1988.

NPTC does not articulate a target capital structure. The Company does, however, perceive itself to be pursuing a very conservative financial strategy. On conventional measures alone, this is clearly not the case. In fact, were it not for the presence of the marketable securities and NPTC's high profitability SCG would be concerned at NPTC's aggressiveness in its capital structure.

(3) NPTC's Additional REA Financings Over The Last Five Years Were Not Required For Construction But Were Beneficial To NPTC and Especially To NPSI

Exhibit VII-3 shows NPTC's sources and uses of cash over the last five years (1983 to 1987). Cash flow over the period was more than sufficient to meet all construction expenditures and even support moderate dividend growth without the additional REA debt financing obtained pursuant to the 1978 loan commitment. Simply summing up the five-year growth in cash equivalents (\$8,010,000 over the 1983 to 1987 period) and comparing this to the net issuance of additional long-term debt over the same period (\$6,160,000) clearly shows that the additional financings were not needed to fund construction or any other of NPTC's investments over the period. The funds served primarily to build up NPTC's large holding of marketable securities and to pay increased and even special cash dividends to the holding company, NPSI. A portion of these dividends were passed along by NPSI to the shareholders as was shown in Exhibit VII-1. Had NPTC not elected to assume the additional debt its balance sheet and capital structure would closely resemble the more conservative nature of its peers (long-term debt to total shareholders' equity ratios in the 65 to 85 percent range).

Nevertheless, the acquisition of this additional funding has clearly benefited NPTC. The company has been able to regularly invest its excess funds at interest rates higher than the 6.85 percent at which it has been able to borrow. It should be noted here that NPTC has stated that every single dollar obtained from the REA has been invested in property, plant and equipment. What is not stated is that internally generated funds were sufficient to fund construction.

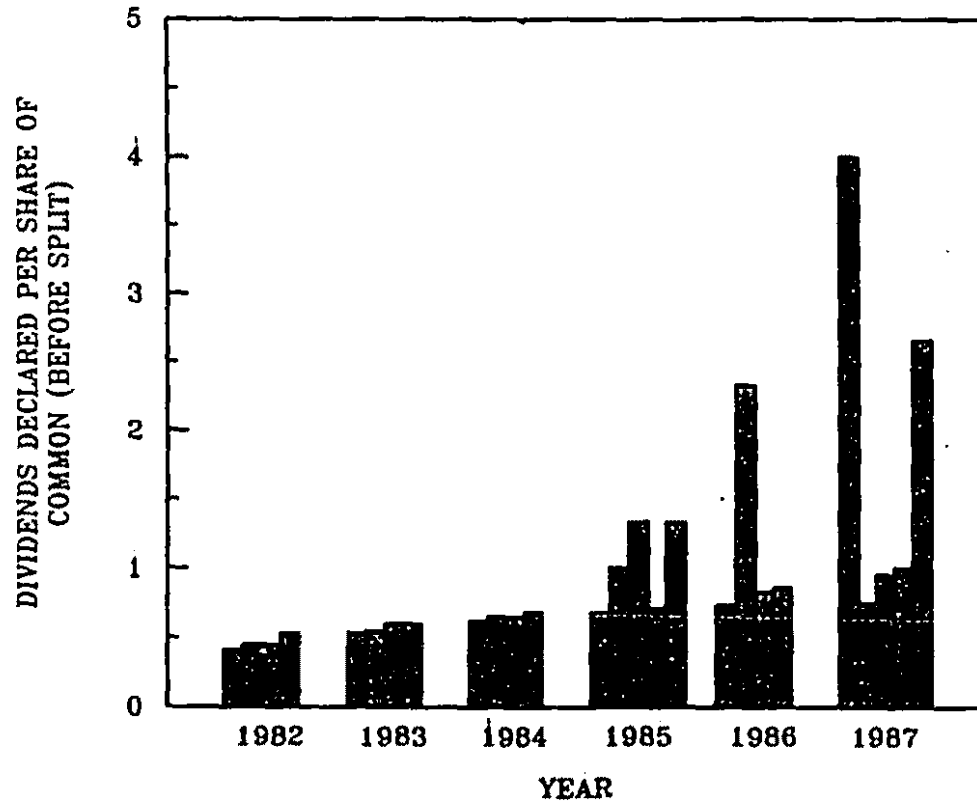
The cash dividends paid by NPTC to the holding company (NPSI) have grown rapidly (38.5 percent compound annual rate) over the 1983 to 1987 period. Exhibit VII-1 illustrated that not all of this cash is reaching the common shareholder. The cash is exiting the regulated entity and is therefore escaping the scrutiny of the Commission. Exhibits VII-4 and VII-5 illustrate the NPTC dividend growth in two different ways. All dividends are shown as if the 5-for-1 stock split of 1986 had not occurred so as to not disguise the dividend growth rate. Exhibit VII-4 shows the actual quarterly (and in 1985 and 1987 the special) cash dividends paid by NPTC to NPSI. Exhibit VII-5 shows the summary by year. Taken together, the exhibits illustrate the dramatic growth in dividends paid by NPTC to NPSI. Neither exhibit shows cash dividends paid by NPSI to the common shareholder. It is important to observe that large amounts of cash are being transferred to NPSI (an unregulated entity) and in 1987 in amounts greater than NPTC's net income.

PENNSYLVANIA PUBLIC UTILITY COMMISSION
MANAGEMENT AND OPERATIONS STUDY OF
NORTH PITTSBURGH TELEPHONE COMPANY

NPTC CASH FLOW SCHEDULE

| <u>Cash Flows From Operating Activities</u> | <u>1983</u> | <u>1984</u> | <u>1985</u> | <u>1986</u> | <u>1987</u> |
|---|----------------|----------------|----------------|----------------|----------------|
| Net Income | 4,107 | 4,825 | 5,522 | 4,551 | 5,999 |
| Items not requiring cash currently: | | | | | |
| Depreciation | 5,100 | 4,347 | 4,565 | 6,139 | 7,117 |
| Deferred income taxes-net | 462 | 422 | 311 | 1,256 | 1,630 |
| Change in inventory | 21 | (28) | 22 | (107) | 85 |
| Change in accounts receivable | (297) | (512) | (3,012) | 2,505 | (1,184) |
| Change in accounts payable | <u>(157)</u> | <u>2,845</u> | <u>(1,181)</u> | <u>2,452</u> | <u>(2,565)</u> |
| Net Cash Provided By Operating Activities | 9,236 | 11,899 | 6,227 | 16,796 | 11,082 |
| <u>Cash Flows From Investing Activities</u> | | | | | |
| Construction Expenditures (Plant Added) | (4,110) | (5,237) | (4,205) | (11,605) | (5,710) |
| Other: | | | | | |
| Investment in Rural Telephone Bank | 142 | | | | |
| Shares of Capital Stock of PTI | | (1,620) | (2,000) | | |
| Pittsburgh SMSA Limited Partnership | | (697) | (18) | (36) | (94) |
| Miscellaneous physical property | <u>(154)</u> | <u>(77)</u> | <u>(166)</u> | <u>7</u> | <u>390</u> |
| Net Cash Used By Investing Activities | (4,122) | (7,631) | (6,389) | (11,576) | (5,414) |
| <u>Cash Flows From Financing Activities</u> | | | | | |
| Issuance (Retirement of Long-Term-Debt) | 1,727 | (278) | (299) | 4,818 | 192 |
| Net Increase in Cash and Temporary Cash | | | | | |
| Equivalents Prior to Dividends | <u>6,841</u> | <u>3,990</u> | <u>(461)</u> | <u>10,038</u> | <u>5,860</u> |
| Payment Of Dividends To Shareholders | | | | | |
| <u>(NPSI After 1984)</u> | <u>(1,751)</u> | <u>(1,991)</u> | <u>(3,833)</u> | <u>(3,609)</u> | <u>(7,074)</u> |
| Net Increase in Cash and Temporary Cash | | | | | |
| Equivalents After Dividends | 5,090 | 1,999 | (4,294) | 6,429 | (1,214) |

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QUARTERLY AND SPECIAL DIVIDEND HISTORY



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ANNUAL DIVIDEND HISTORY

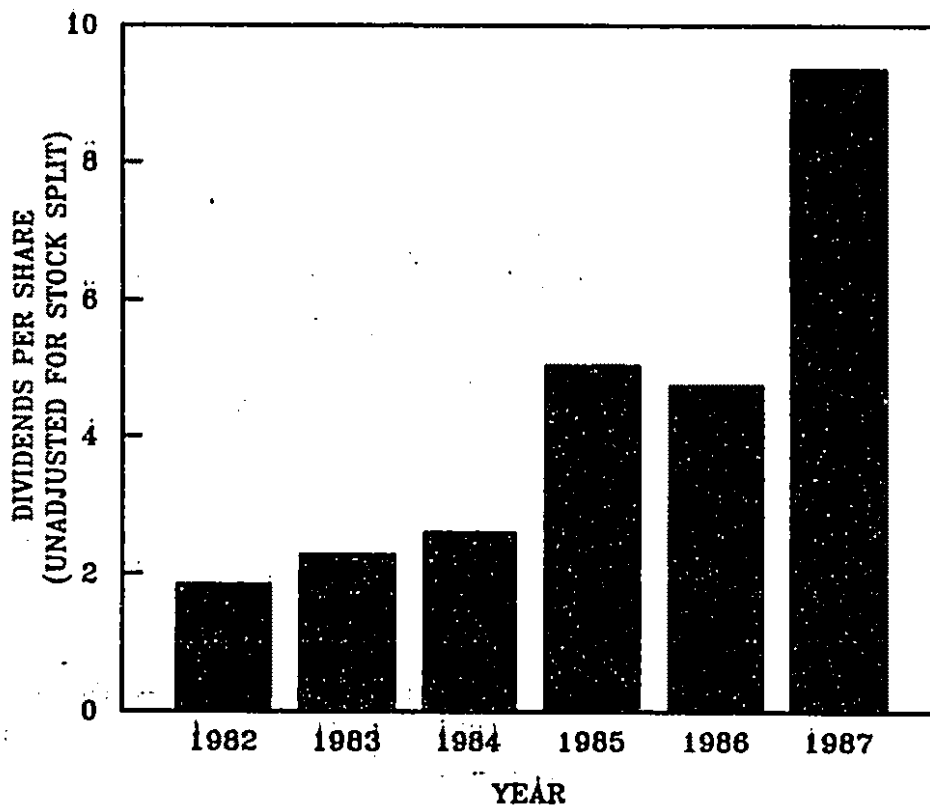


EXHIBIT VII-5

Source: PAPUC Form M; SCG Analysis

(4) An Allowed Rate Of Return On Equity Has Not Been Established For NPTC And The Company Has Been Earning Returns That Are Much Higher Than Industry Averages

NPTC has not had a rate case since 1969. As a result, its local service rates are among the lowest in the Commonwealth (local service revenue represents about 20 percent of NPTC's total revenue). The 1969 rate case did not set an allowed rate of return on equity; it only established a rate of return on rate base which assumed a weighted average cost of capital (WACC). Hence, an updated allowed rate of return on equity does not exist.

The determination and assessment of NPTC's actual rate of return on equity merits discussion because two different regulatory jurisdictions are involved. The Pennsylvania Public Utility Commission's purview extends to local rates and intrastate toll revenue. The Federal Communications Commission (FCC) regulates NPTC's interstate toll revenue. The FCC has set an allowed rate of return on equity of 12 percent. An analysis of the intricacies surrounding the basis and rationale for these rate of return on equity determinations is beyond the scope of this study. What is important to observe is that NPTC is overearning relative to industry norms regardless of the regulatory jurisdiction involved.

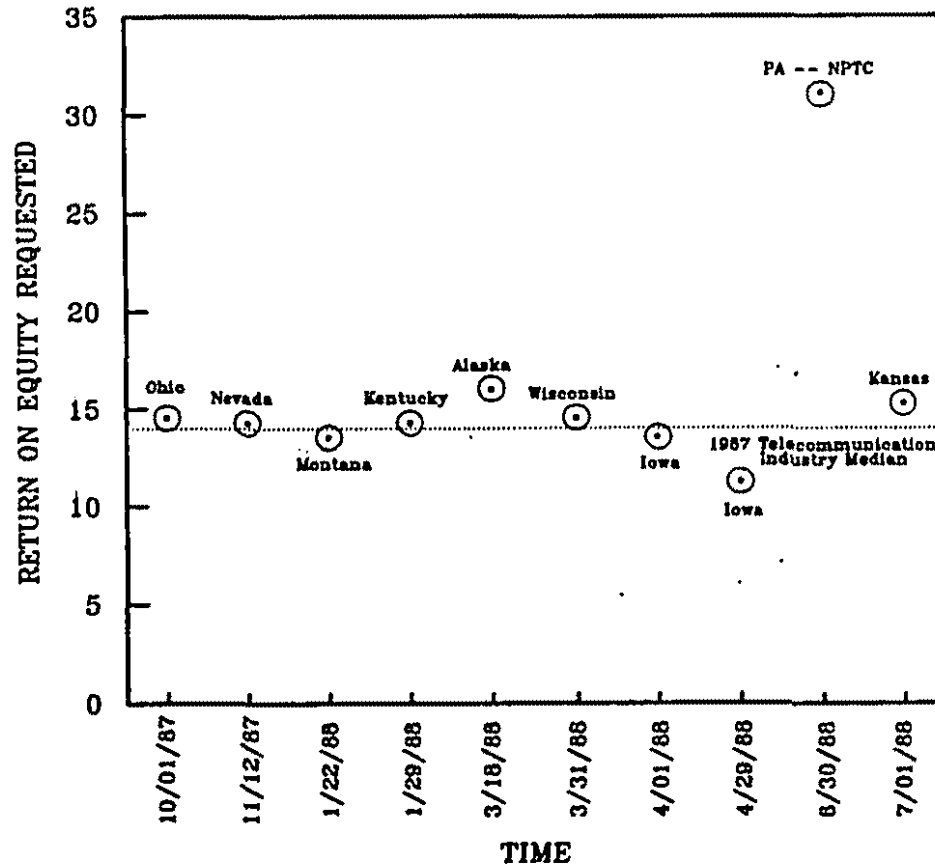
The magnitude of NPTC's recent rate of return on equity relative to its peers can be seen in Exhibit VII-6. SCG examined the requested rates of return on equity in various telephone rate cases around the United States over the past year and found that NPTC's actual ROE was considerably higher than usual. The fact that NPTC is so profitable explains many of its financial actions over the past several years. It certainly creates powerful incentives to expense (rather than capitalize) items and to increase depreciation expense, which is what NPTC has done. It also creates an incentive to move cash as quickly as possible to an unregulated entity and to therefore avoid a potential regulatory initiative to recapture excess profits and return associated savings back to the ratepayer. Whether or not this should be pursued through a Pennsylvania Public Utility Commission proceeding or a Federal Communications Commission proceeding is unclear. NPTC's reported rates of return on equity would suggest that the bulk of the excess earnings are from operations under FCC jurisdiction.

Potential ratepayer savings associated with NPTC being reduced to a level of typical telecommunications industry profitability are enormous. Exhibit VII-7 is a simplified pro forma income statement that we prepared to show the drop in revenue requirements associated with a return of NPTC to normal profitability. Revenue requirements drop 18.5 percent or \$5.205 million per year.

Because NPTC's local rates are among the Commonwealth's lowest, SCG believes that NPTC's toll revenue volume explains its high profitability. To simply assert that the Company's local rates are low is misleading. It only derives 20 percent of its revenues from local service. The Company's revenue and profit generator is toll calls.

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REQUESTED RETURN ON EQUITY IN RECENT RATE CASE VS
 INDUSTRY MEDIAN AND NPTC ACTUAL



Sources: Public Utilities Fortnightly (various, 1988) Forbes, January 11, 1988, NPTC Data Request # 145; SCG Analysis

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PRO FORMA OPERATING STATEMENT ASSUMING
INDUSTRY MEDIAN RETURN ON EQUITY

| | North Pittsburgh Telephone Company Operating Statement as of <u>June 30, 1988 (Actual)</u> | Pro Forma North Pittsburgh Telephone Company Operating Statement as of June 30, 1988 <u>Assuming 13.8 Percent ROE</u> | Revenue Requirement <u>Difference</u> |
|---|--|--|---|
| <u>Operating Revenue</u> | \$28,188 | \$22,983 | \$5,205 |
| Less: Operating Expenses | 10,149 | 10,149 | - |
| Depreciation | <u>6,609</u> | <u>6,609</u> | <u>-</u> |
| <u>Earnings Before Interest and Taxes</u> | \$11,430 | \$6,225 | \$5,205 |
| <u>Taxes</u> | | | |
| Less: Gross Receipts | 572 | 460 | 112 |
| Capital Stock | 315 | 315 | - |
| Other | 18 | 18 | - |
| State Income | 788 | 429 | 359 |
| Federal Income | 3,054 | 1,663 | 1,391 |
| Investment Tax Credit | <u>(454)</u> | <u>(454)</u> | <u>-</u> |
| <u>Income Available For Return</u> | \$7,139 | \$3,798 | \$3,343 |

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PRO FORMA OPERATING STATEMENT ASSUMING
INDUSTRY MEDIAN RETURN ON EQUITY

- Notes:
- 1) Income Available For Return was calculated so as to provide a 13.8 percent return on equity to the common stockholder.
 - 2) The Industry median return on equity was 13.8 percent in 1987 according to Forbes magazine in its January 11, 1988 issue.
 - 3) Gross Receipts taxes were assumed to remain 2 percent of Operating Revenues.
 - 4) Capital Stock taxes were assumed to stay constant.
 - 5) Other taxes were assumed to stay constant.
 - 6) State Income taxes were assumed to remain 8.9 percent of Earnings Before Interest and Taxes.
 - 7) Federal Income taxes were assumed to remain 28.7 percent of Earnings before Interest and Taxes.
 - 8) Investment Tax Credit was assumed to stay constant.
 - 9) Operating Expenses and Depreciation do not change.

Sources: NPTC Data Request # DR 145, PAPUC form M, Forbes, January 11, 1988.

(5) Internally Generated Funds Will Be Sufficient To Satisfy NPTC's Construction Expenditures And Other Anticipated Investments Over The Next Five Years

At current profitability levels NPTC will not require external financing over the next five years. The Company's construction program will not be as extensive now that the digital conversion effort is nearing completion. Increased depreciation expense has been contributing to strong positive cash flow. The increase in depreciation expense over the 1984 to 1987 period amounted to \$2.77 million per year. A portion of this escalation is attributable to the early retirement (due primarily to technical obsolescence) of assets that were replaced during the digital conversion. Another part of the depreciation expense increase is due to NPTC's shortening of the estimated useful lives of certain classes of assets. Exhibit VII-8 indicates these trends. It should be noted that these trends have been common throughout the telecommunications industry.

NPTC is in a fairly enviable position with respect to many of its peers with respect to its overall financial and strategic position. It already possesses an extremely modern network that should require fewer resources to maintain than the one it replaced. The Company's high profitability and shortening of the useful lives of assets (which increases depreciation expense) have provided and could continue to provide strong positive cash flow.

(6) Internal Control And Managerial Oversight Of Disbursement Are Appropriate

All NPTC disbursements require the approval and signature of a Company officer. Disbursements over \$5,000 require two officer's signatures and are generally reviewed by the President as well. The Company Treasurer routinely reviews all major invoices. This level of attention and separation of approval authority is appropriate and is indicative of adequate internal control of disbursements.

There is a minor opportunity for improvement with the signature authority (buying level authority) afforded NPTC's Supply Supervisor, but this issue is discussed in the Chapter VI.

(7) NPTC's Investment In The Pittsburgh SMSA Limited Partnership Continues To Consume Cash

NPTC holds a 3.6 percent equity stake in the Pittsburgh SMSA Limited Partnership. The Partnership's purpose is to provide cellular telephone service to the greater Pittsburgh metropolitan area. The topography of the Pittsburgh area has presented unanticipated technical problems (primarily reception-related) and these difficulties have required the Partnership to install additional equipment.

Thus far, the Partnership (which includes Bell Atlantic and Alltel) has not been a financial success. The NPTC equity in undistributed net losses of the Partnership was \$190,000 and \$117,000 for 1987 and 1986, respectively. Perhaps more significantly, the Partnership continues to require additional cash. Simply maintaining the 3.6 percent stake required additional NPTC capital infusions of \$94,000 and \$36,000 in 1987 and 1986, respectively.

**PENNSYLVANIA PUBLIC UTILITY COMMISSION
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DEPRECIATION ANALYSIS



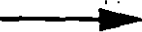

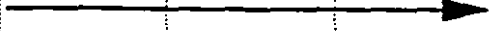
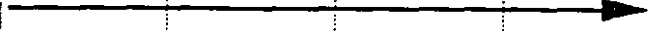



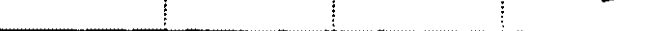
| Plant Account | Balance on 12/31/86 (in 000's) | Percent of Total Depreciable Plant | Average Service Life Of Depreciable Plant | | | | | | |
|---|--------------------------------------|--|--|--|------|----------|-----------|---|----------|
| | | | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | |
| Buildings | \$ 3,931 | 5.9% | 50 Years |  | | | | | 30 Years |
| Central Office Equipment | 25,692 | 38.5 | 18 |  | | 15 Years | 10 Years: |  | |
| Station Connections | 2,649 | 4.0 | 11.78 | 6.67 Years  | | | | | |
| Pay Stations | 405 | 0.6 | 18 |  | | | | 8 | 4 |
| Pole Lines | 3,377 | 5.1 | 20 |  | | | | | 14 |
| Aerial Cable | 14,904 | 22.4 | 30 |  | | | | | 20 |
| Underground Cable | 1,263 | 1.9 | 35 |  | | | | | 20 |
| Buried Cable | 5,375 | 8.1 | 25 |  | | | | | 20 |
| All Others (Vehicles, Furniture, Etc.) | 8,995 | 13.5 | N/A |  | | | | | N/A |
| TOTALS | \$68,590 | 100.0% | Notes: 1) In no instance did NPTC lengthen average service lives. 2) Decreasing average service lives increases depreciation expense, increases cash flow, and decreases net income. 3) Decreasing average service lives (increasing depreciation expense) lowers near-term return on equity (ROE). 4) The table only shows service life changes. | | | | | | |

EXHIBIT VII-8

Source: PAPUC Form M; SCG Analysis



NPTC's initial and ongoing participation in the Partnership is indicative of NPTC's strategy to be a full-line provider of telecommunication services. NPTC believes that it must be able to offer its customers a full array of services to reduce the possibility that a competitor gains a foothold in NPTC's service territory. SCG believes that this business strategy is generally sound and therefore believe NPTC's continuing investments in the Pittsburgh SMSA Limited Partnership are appropriate subject to some final investment limit and the reasonable prospect of reaching a break-even point in a certain timeframe.

(8) Use Of Working Capital Can Be Improved

NPTC's ability to control the growth of accounts receivable has been affected by the Commission's Chapter 63. As explained in Chapter VI, SCG believes that significant opportunities exist to modify existing customer deposit and customer late charge policies such that overall accounts receivable performance improves.

NPTC attempts to limit its overall materials and supplies investment (inventory) to less than \$1,000,000. The Company's ability to achieve this target has been mixed, in part because inventory control responsibility is too widely dispersed. Furthermore, lower-level personnel that highly influence inventory levels (through sparing philosophies, safety stock levels, etc.) do not have specific dollar limits to guide their decisions. As a result, SCG believes that the discussion of the NPTC Supply function (described in Chapter VI) will improve the Company's ability to control and possibly reduce its inventory investment level.

The cash flow schedule presented in Exhibit VII-3 illuminates NPTC's cash flows. This analysis indicated that there have been wide variations in the magnitude of accounts receivable and accounts payable. These variations are not attributable to the Company's core telephone operations but rather to other receivables and payables. They are related to transactions between NPTC and the unregulated subsidiaries of NPSI.

(9) NPTC's Cash Management Practices Are Appropriate

NPTC uses Pittsburgh National Bank (PNB) for its payroll accounts, general accounts and a retail lockbox operation. NPTC has had a banking relationship with PNB for many years. Over 90 percent of NPTC's total revenue is paid by mail through the retail lockbox operation at PNB. All receipts are cleared daily and are deposited to NPTC's account. NPTC also deposits all collections from its Business Office (in Gibsonia) on a daily basis.

On the cash disbursement side, NPTC builds up its cash balances to meet quarterly outlays such as Federal Income Tax Payments, Pennsylvania Income Tax Payments and REA interest payments. Additional balances are built up for large annual items such as the Retirement Plan deposit. Cash is placed in short-term vehicles such as certificates of deposits, bankers' acceptances and the like through PNB at maturities which coincide with anticipated disbursement times. Other known items are posted to a rolling schedule which indicates the magnitude of upcoming outlays.

(10) NPTC Does Not Develop Or Use Annual Operations And Maintenance Budgets

Operations and maintenance (O&M) budgeting is a critical managerial control process. An O&M budgeting process should be closely linked with a Company's profitability planning. O&M budgeting is generally performed after specific profitability targets are set. These profitability targets establish and set limits on what expenditure levels ought to be to achieve the desired profitability. In most companies, therefore, an O&M budget helps to control ongoing outlays such that profitability will be sufficient to ensure long-term success.

A well-conceived and effective O&M budgeting process should instill a cost control awareness down to lower levels of an organization. Ideally, supervisors should be held responsible for keeping those costs that they have control over within certain targets. Perhaps more importantly, the O&M budgeting process channels available resources to areas that are planned in advance.

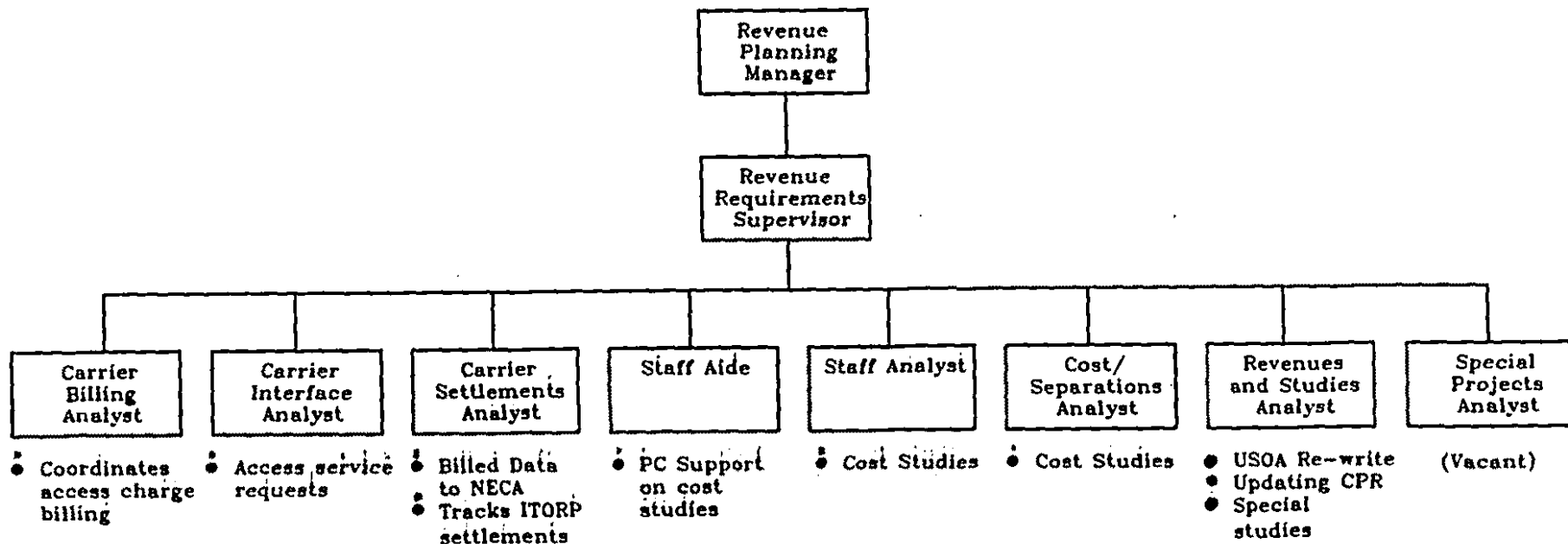
NPTC does not employ an O&M budgeting process. The Company believes that its key managers are able to provide sufficient control over expenditures without one. NPTC is extremely profitable, and the Company enjoys strong positive cash flow, a situation that has in all likelihood reduced NPTC's sense of urgency to institute more stringent controls. Nevertheless, SCG believes that NPTC needs to introduce an O&M budgeting process particularly in view of the Company's continued growth and the increasing level of competition in the telecommunications industry.

(11) Overall, NPTC's Revenue Planning Function Is Appropriately Structured

An effective Revenues Organization should be structured to effectively plan, manage, and control the Company's different revenue streams. This role is becoming increasingly important as the distinctions between the local, toll, and access revenue streams continue to blur and the relationships between the revenue streams make their forecasting and tracking more difficult. NPTC's revenue planning organization activities include the development of revenue plans and objectives; the tracking and analysis of the local, toll and access revenue streams; the monitoring of jurisdictional financial performance in concert with Finance; and regulatory relations. An organization chart of NPTC's Revenue Planning function is shown in Exhibit VII-9 on the following page. Responsibility for analyzing and monitoring all revenue streams, regulatory response on revenue streams (pro forma or actual), and any review coordination with other TELCOs, NECA or the interexchange carriers resides in the same organization.

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ORGANIZATION OF REVENUE PLANNING



C - RECOMMENDATIONS

Evaluate Lowering Ratepayer Service Costs By Reducing The Costs To Customers Of Service, And Particularly Toll Service, To Customers (Ref. Finding 4)

There are many different ways to address NPTC's overearnings situation, a detailed analysis of which was beyond the scope of this study. Without intimate knowledge of the many NPTC revenue streams, and the costs associated with sustaining them, meaningful revenue reduction recommendations are very difficult to formulate. The situation is further complicated by the fact that two different regulatory jurisdictions are involved. Nonetheless, the level of NPTC's earnings argues for lower ratepayer costs.

NPTC has characterized itself as a "toll machine", a characterization that appears accurate and that identifies where the bulk of revenue reduction should occur. The following recommendation is based on this situation and is but one way to begin to correct the fact that NPTC's ratepayers are providing the Company's with aggregate revenues that far exceed industry norms.

NPTC should conduct a study to evaluate and document the effects of offering services such as the Extended Area Service, The Circle Calling Plan, or other services at a significantly reduced rate. The plan ought to be revenue negative, which would help restore NPTC's earnings to normal levels. It would also avoid a complicated and lengthy rate proceeding.

Expansion of the number of customers experiencing reduced toll costs would have extremely positive customer satisfaction effects. In its own customer service surveys NPTC's customers have consistently expressed discontent with the Company's limited free local calling area. A bold move by NPTC to offer a much lower cost toll service would further bolster the Company's image, stimulate additional growth, and relieve ratepayers and partially correct NPTC's overearnings situation.

Establish Both Time And Resource Limits Regarding NPTC's Continuing Investment In The Pittsburgh SMSA Limited Partnership (Ref. Finding 7)

By December 31, 1987, NPTC had invested nearly \$1.044 million in the Pittsburgh SMSA Limited Partnership. Because of continuing Partnership losses, the book value of NPTC's investment stood at \$494 thousand at the end of 1987. Nevertheless, NPTC believes that the Partnership is viable and that additional investments will be recouped. The Company should establish its thresholds, in both time and investment, at which it intends to reassess that conclusion.

Improve Use Of Working Capital (Ref. Finding 8)

Recommendations regarding the use of working capital are included in Chapter VI because working capital use is largely affected by NPTC departments other than Finance, and working capital improvement opportunities are best discussed in the context of the departments best-suited to effect the improvement. As a result, potential accounts

receivable improvements are discussed in the findings and conclusions regarding the Service Department, and potential materials and supplies improvements are discussed in the findings and conclusions regarding the Supply Administration group.

Develop And Implement An Annual Operations And Maintenance Budgeting Process
(Ref. Finding 10)

NPTC should develop and implement an O&M budgeting process. This process should include the creation of distinct cost centers throughout NPTC. These cost centers should closely parallel organizational alignment. All foreseeable NPTC labor, contract labor, consumables, materials and supplies, and administrative expenses over the upcoming year should be identified and quantified. Managers should be held responsible for budget performance on those expense items within their control. Monthly reporting of actual expenses relative to budgeted expenses should be provided and a variance reporting requirement should be used to explain all variances outside of a specified band.

NPTC could develop a workable O&M budgeting process in about one year. NPTC should plan to implement the O&M budgeting process reporting around January 1990. This would require that budgets be prepared in the Fall of 1989.