

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF CINCINNATI BELL)
TELEPHONE COMPANY FOR AUTHORITY)
TO INCREASE AND ADJUST ITS RATES AND) CASE NO. 98-292
CHARGES AND TO CHANGE REGULATIONS)
AND PRACTICES AFFECTING SAME)

O R D E R

In August 1998, Cincinnati Bell Telephone Company ("CBT") filed a proposed alternative regulation plan and requested authority to adjust its rates. The Commission suspended the proposed tariff until January 23, 1999. AT&T Communications of the South Central States, Inc. ("AT&T") and the Attorney General's Office of Utility and Rate Intervention ("AG") intervened in this proceeding. Informal conferences were held on November 13 and December 2, 1998. Both intervenors entered into stipulated settlements with CBT prior to the December 17, 1998 hearing.¹

On April 9, 1998, CBT received approval of a new alternative regulation plan for its Ohio operation. Because of CBT's desire to maintain rate uniformity throughout its entire service area, CBT filed the current application to generally mirror the provisions and rate levels approved for its Ohio operation.

PROPOSED ALTERNATIVE REGULATION PLAN

In its application, CBT proposed that its services be divided into three cells and regulated according to the competition experienced by the services within each cell.

¹ CBT's December 10, 1998 filing, at Attachments I and II.

Cell 1 contains those services that provide access to CBT's network and services deemed essential for the provision of public service/basic local exchange services. Cell 2 contains discretionary local exchange services or any other public service, including installation charges, for which an alternative service is available. Cell 3 contains those services deemed fully competitive. CBT proposes that "exogenous costs" would be recoverable above the proposed ceilings for Cell 1 and Cell 2. The Commission adopts CBT's proposal, as modified by its stipulation with the AG and other revisions discussed herein. These revisions are necessary to find the alternative regulation plan is in the public interest.

Two Stipulations

CBT and the AG agree to the following terms. There will be no rate increase in basic local service for residential customers for at least three years except for changes due to "exogenous costs," including surcharges mandated by a state or federal regulatory agency, a commitment to maintain service quality standards and to furnish the AG with periodic service quality information, a one-time credit to residential LAS customers in certain exchanges to facilitate the elimination of LAS in those areas, and a limitation on the pricing parameters for certain classes of services and an alteration in the cell structure of the service categories for CBT.

CBT and AT&T addressed a reduction in switched access rates in their stipulation. The reduction would begin upon receipt by CBT of support from the intrastate Universal Service Fund.² The first reduction would occur on July 1, 1999 and

² See Administrative Case No. 360, An Inquiry Into Universal Service and Funding Issues.

the second on approximately July 1, 2000. The purpose of these reductions is to eliminate any windfall which could be caused by the receipt of Universal Service Funds with no reduction in existing rates. The switched access rate reduction would equate to 54 percent of CBT's estimated initial high cost Universal Service Fund support. According to the stipulation, increases or decreases in the level of reductions would depend upon future levels of high cost Universal Service Fund support.

The Commission has reviewed these stipulations and the AG's settlement is approved. Accordingly, there shall be no residential rate increases for three years from the date of this Order, except as specified herein. According to the settlement with the AG, Cell 1 services do not change, although non-residential access lines shift from non-core to core. Residential core services in Cell 1 have no upward pricing flexibility while non-residential non-core services have 10 percent upward annual pricing flexibility. Non-residential core services and residential non-core services have 5 percent annual upward pricing flexibility. Under the AG's settlement, the original Cell 2 is divided into two cells: the first contains selected network and basic exchange-related services that have competitive alternatives, specifically special access, intraLATA MTS and certain directory assistance services. This cell has a ceiling rate capped at 50 percent over the initial authorized rate for the first three years and could increase by 10 percent per year in subsequent years. Cell 3 as agreed to in the stipulation with the AG primarily contains discretionary services and optional features. Its rate ceiling is capped at 75 percent over the initial authorized rate for the first three years and could increase by 15 percent per year in each subsequent year. Moreover, the Commission approves the cell structure alterations agreed to by the AG and CBT.

The Commission finds the concept contained in the AT&T and CBT stipulation reasonable. However, due to the interrelationship between switched access rates for AT&T and for other carriers, the fact that the Commission has made no final determinations on the high cost Universal Service Fund, including where any reductions should take place, the agreement is not explicitly approved.

Modifications

CBT must make the following modifications to its plan:

Unused Increases. CBT proposes that it be given upward pricing flexibility of 10 percent per year over the initial rate authorized by the Commission. Moreover, it proposes that any upward rate flexibility which it fails to use may be implemented in future periods. This portion of CBT's proposal is denied. The restrictions which the Commission seeks for rate flexibility in each of the cell groups are to protect ratepayers from any unwarranted rate increases or rate shock. It is inappropriate for CBT to bank unused rate flexibility and then institute a rate increase in excess of 10 percent in some future year.

Exogenous Costs. CBT proposes that exogenous costs be recovered from "non-core services." It defines exogenous costs as those imposed on it by external events such as tax law changes, court decisions, access charge restructuring, regulatory changes or costs associated with introducing competition. The proposed recovery of exogenous costs is unreasonable. One of the purposes of instituting an alternative regulation plan as proposed by CBT is to enable the utility adequate flexibility within its own pricing to recover costs that affect it. The Commission believes that the alternative regulation plan adopted herein enables CBT adequate flexibility to respond to many of

the costs which CBT defines as exogenous. This feature of CBT's proposal is hereby denied. CBT may petition the Commission to recover specific discrete costs brought about by tax law changes or regulatory changes, but it may not do so in the automatic manner which it proposes.

Productivity Factors. CBT argues that no productivity factor is necessary for its alternative regulation plan. It asserts that the inflation rate will be an implicit productivity factor for the residential rates given the three-year freeze of those rates. This is an insufficient measure. CBT's implicit productivity factor would not compensate and may insufficiently capture productivity gains. The Commission believes that all customers should benefit from CBT's productivity gains. Typically to implement a productivity offset, the gains of a utility are measured at a given point in time. If the utility achieves a greater productivity than the offset, then it keeps the increased earnings, but monies equal to or below the productivity offset are returned to the ratepayers. Without such a productivity offset, any increases in CBT's productivity will not be shared with the ratepayers. Because the procedure for such an offset is complicated and the Commission seeks to maintain an alternative regulation plan for Kentucky as similar to Ohio as practical, no productivity factor offset will be ordered. However, the Commission will require that CBT share its earnings with its ratepayers as described below.

Need for Sharing. In order to share any efficiency gains with Kentucky ratepayers, the Commission hereby requires that CBT establish a procedure to share its earnings. As noted below, the Commission has adopted a range of 12.5 – 13.5 percent return on equity. For earnings of 13.5 percent and above, all earnings will be shared in

the ratio of 50:50 between CBT and the ratepayer. CBT should file its calculation of the rate of return and the earnings sharings annually for three years. Information for the first year should be filed one year from the date of this Order. For any earnings above 13.5 percent, CBT should file a tariff crediting each of its Kentucky access lines for an amount totaling 50 percent of its earnings above 13.5 percent. No sooner than three years from the date of this Order, CBT may request a change in the sharing mechanism for this alternative regulation plan.

To address the details of this sharing mechanism and the financial documents that CBT must file with the Commission to support its rate of return calculations, the Commission herein schedules an informal conference.

Service Quality and Consumer Complaint Issues

The Commission will monitor CBT's quality of service to ensure that its performance does not fall below the minimums required by Commission regulation. CBT has committed to maintaining its quality of service.

The Commission will continue to consider consumer complaints according to the regulations. The alternative regulation plan will not affect the complaint process.

Filing Revised Plan As A Tariff

CBT shall file a separate section of its tariff containing all of the cell structures, rates and conditions of service for its alternative regulation plan, including access charges, approved herein. This tariff must also include CBT's proposed term (i.e., 3 years) for the alternative regulation plan and the mechanism for determining the sharing of earnings in excess of 13.5 percent.

Rate of Return

CBT proposed a return on equity of 13.6 percent. The Commission finds that the range of 12.5 – 13.5 percent return on equity allowed CBT in Case No. 94-355³ continues to be just and reasonable and will enable CBT to attract capital, provide an appropriate return to its shareholders, and result in reasonable cost to its ratepayers. For purposes of determining the revenue requirements herein, the midpoint of 13 percent has been used.

REVENUE REQUIREMENTS

Test Period

CBT proposed and the Commission accepted the 12-month period ended December 31, 1997 as the test period.

Capital

CBT used its end of test period capital structure consisting of 66.9 percent equity and 33.1 percent debt. The embedded cost of debt used by CBT was 7.98 percent. The Commission finds that CBT's capital structure and embedded debt costs are reasonable.

Revenues and Expenses

CBT reported adjusted intrastate net operating income of \$10,812,000.⁴ It also filed two analyses which included a directory imputation and which reflected a revenue sufficiency of \$378,000. This revenue sufficiency equaled CBT's proposed revenue

³ Case No. 94-355, Application of Cincinnati Bell Telephone Company For Authority to Increase and Adjust Its Rates and Charges and to Change Regulations and Practices Affecting the Same.

⁴ CBT's December 10, 1998 filing, at Attachment III.

reduction of \$378,000.⁵ On January 6, 1999, CBT increased its net operating income to \$11,851,000.⁶ The increase resulted from the removal, prior to normalization, of expenses being recognized as individual components in the revenue requirement analysis. Expenses removed were in the "Number Services" account and the "Information Management" account to reflect a change in the booking of CBT's prepaid directory expense and expenses for year two thousand compliance, respectively. The revenue and expense normalization method reflected in the January 6, 1999 filing was provided in response to a Commission request. CBT also submitted two additional net operating income estimates based on expense normalizations which were not introduced prior to the hearing and were not requested as late-filed exhibits. The first of these scenarios annualized expenses from the fourth quarter based on date-certain quantities. This produced a revenue deficiency of \$134,000. The second scenario annualized December 1997 expenses based on date-certain expenses excluding non-recurring items and produced a revenue deficiency of \$3.6 million. Because CBT did not timely furnish this information and the Commission has not had an adequate opportunity to evaluate these methods, it would be unreasonable to consider them in establishing CBT's adjusted intrastate net operating income.

Directory Revenue

Cincinnati Bell Directories ("CBD") supplies telephone directories for CBT. The companies are affiliates by virtue of common ownership by Cincinnati Bell Incorporated.

⁵ Id., at Attachment VII.

⁶ CBT's January 6, 1999 filing, at Attachment 1(a), 1 of 3.

CBD does not publish directories for any other company.⁷ Yellow pages are a separate publication from the White Pages Directory,⁸ even though there is a common distribution. CBT does not receive yellow pages advertising revenue from CBD.⁹ In 1997, CBT and CBD signed a new directory publishing agreement changing the method of settlement and dramatically reducing the revenue flowing to CBT. For instance, for the years 1994 through 1996, directory revenues for CBT were \$4.6 million, \$4.8 million, and \$5.1 million, respectively, while directory revenues booked in 1997 were \$2 million. CBT asserts that the new contract with CBD removes implicit subsidies as required by the Telecommunications Act of 1996 ("the Act"). CBT argues that subsidies like the Yellow Pages Directory revenue imputation should no longer exist in a competitive environment.¹⁰

The Commission has historically required the imputation of revenues associated with the publication of telephone directories and the sale of yellow pages and has done so in CBT's previous case.¹¹ The Commission continues to believe that such an imputation is necessary to reflect the fact that the provision of directories and yellow pages has been and will continue to be an integral part of basic local service. This opinion is supported by decisions made at divestiture which required that directory activities including the sale of yellow pages advertising remain with the local exchange

⁷ Transcript, p.18, lines 2-3.

⁸ Id., at 12, lines 8-11.

⁹ Id., at 12, lines 12-21.

¹⁰ Id. at 22, lines 22-25.

¹¹ Case No. 94-355.

companies to provide support for affordable rates. The Commission is not persuaded to change its position on yellow page imputation by CBT's argument that the new contract between CBT and CBD was designed to comply with the Act regarding subsidies.

Accordingly, an adjustment to CBT's directory account is necessary. CBT will be able to adjust its rates, moving them toward costs and removing existing implicit subsidies as it sees fit. To determine the appropriate imputation, the Commission requested CBD information consistent with that obtained by the AG's witness in CBT's Case No. 94-355. In that case, CBD's earnings above a reasonable pre-tax return on investment of 15 percent were determined for Kentucky and imputed to CBT's Kentucky operations. The imputation was \$2.6 million. In this case the same methodology was applied to the information provided by CBT; however, the result was an imputation which was significantly greater than the imputation in Case No. 94-355 and appeared unreasonable. Additional information received from the company did not provide information necessary to recalculate a new imputation. Therefore, based on comparisons of booked directory revenues for the years 1994 through 1996 with those booked in 1997 under the new contract and the directory revenues booked in the test period in Case No. 94-355 and the revenue imputation, the Commission finds that a revenue imputation equal to the \$2.6 million found appropriate in Case No. 94-355 is reasonable.

Resale Issues

CBT requested the Commission to proactively address issues concerning the resale requirements in the Act.¹² The Commission has previously ruled on these resale

¹² Marshall Testimony, Volume 5, at 14, lines 10-16.

issues in arbitration proceedings in Case Nos. 96-440¹³ and 96-431.¹⁴ These determinations will be applied to CBT's resale activities in Kentucky, absent CBT's presentation of persuasive arguments to the contrary.

Depreciation

CBT requests maximum flexibility regarding depreciation issues. It argues that the alternative regulation plan places the company's risk clearly on the shareholders and that depreciation decisions should likewise be in their hands. Generally, CBT should be allowed to make its own decisions concerning depreciation. However, this level of flexibility poses certain dangers to ratepayers.

Effective competition does not yet exist in many markets and ratepayers should not bear increased burdens due to increased flexibility. CBT must still make periodic depreciation filings with the FCC and should provide this information to the Commission. In this manner, the Commission can track CBT's depreciation decisions and interact with the FCC to ensure that assets are depreciated in a timely and reasonable manner. This monitoring process should not impose any undue competitive hardship on the company.

¹³ Case No. 96-440, Petition by MCI for Arbitration of Certain Terms and Conditions of a Proposed Agreement With GTE South Incorporated Concerning Interconnection and Resale Under The Telecommunications Act of 1996.

¹⁴ Case No. 96-431, Petition by MCI For Arbitration of Certain Terms and Conditions of a Proposed Agreement With BellSouth Telecommunications, Inc. Concerning Interconnection and Resale Under The Telecommunications Act of 1996.

Revenue Requirements Summary

Required Net Operating Income	\$ 11,601,000
Adjusted Net Operating Income	<u>13,545,000</u>
Sufficiency	1,944,000
Multiplier	x <u>1.574789</u>
Revenue Sufficiency	<u>\$ 3,061,000</u>

RATE DESIGN

Rate Uniformity

CBT seeks to maintain rate uniformity between its Ohio and Kentucky operations. It argues that uniform rates in its entire service area will lessen administrative costs, enhance marketing efficiencies in sales, service and promotions, and generally minimize customer confusion. CBT emphasizes that it serves a single LATA and that it generally serves the Consolidated Metropolitan Statistical Area on a local basis.

This Commission has a long history of finding uniform rates reasonable for most services. Certain services such as access charges and payphones are unique to each jurisdiction. Although the Commission continues to find rate uniformity reasonable, with the exceptions detailed herein, it is incumbent upon CBT to continue to provide information to the Kentucky Commission that uniform rates remain in the public interest. The Commission will continue to review this issue in future analysis and expects CBT to continue to provide detailed workpapers showing the differences between the revenue split and jurisdictional separation methodologies.

Rate Bands

CBT proposed to restructure its service area into rate bands, rather than rate groups. Rate bands are geographic rate areas as defined by access line density by

wire centers within CBT's service area. It has proposed to replace the long established rate group structure which was based on the number of access lines within an exchange. Generally this proposal would have little impact on CBT's customers. However, approximately 113 residential customers, who would have had the greatest increases, will receive a one-time credit equal to the change in rates as if they were phased in over three years, as defined in the AG's stipulation. Thus, the Commission finds this restructure to be reasonable.

Modifications to CBT's Proposed Rate Structure

CBT's December 10, 1998 filing reflects a summary of annual revenue changes as originally filed and as revised for the 1997 test period.¹⁵ The Commission finds this is an appropriate basis upon which to modify CBT's rate structure for the revenue sufficiency discussed earlier.

Payphone Rates. On January 3, 1999, the Commission entered an Order in Administrative Case No. 361, Deregulation of Local Exchange Companies' Payphone Service. In that Order, the Commission established the rates for CBT's payphone service at \$30.45 for "smart" sets and \$38.04 for "dumb" sets. To recognize this Order, CBT filed a letter further reducing rates approximately \$469,000.¹⁶ The Commission concurs in this change.

Access Charges. In its original application, CBT proposed to change its intrastate access rates to mirror its interstate rates and rate structure then in effect, except for Carrier Common Line ("CCL") and the newly introduced Presubscribed

¹⁵ CBT's December 10, 1998 filing, at Attachment VII.

¹⁶ January 6, 1999 letter revising Attachments VI and VII.

Interexchange Carrier Charge ("PICC"). CBT proposed two additional rate changes at the federal level, the latest occurring January 1, 1999. Using these rates to mirror Kentucky intrastate test year data results in a reduction in switched access of \$378,489 and a reduction in special access of \$84,410 from test period levels.

CBT and AT&T have stipulated to the methodology for the future reduction of access charges. The stipulation is based upon the premise that the imputed intrastate PICC is revenue neutral with switched access service and CCL rates at interstate levels. In its January 6, 1999 filing, CBT states that the stipulation would offer a better means to reduce access rates toward costs than simple mirroring because the stipulation was expected to result in larger decreases in switched access rates, reduce CCL rates to zero and not introduce PICC. The Commission believes these terms have merit, but the issues are pending decision in Administrative Case No. 360.

Thus, the Commission sees no reason that reductions currently for switched access and CCL rates would be counter to the stipulation. It would simply modify the percentage within the stipulation. Therefore, CBT should reduce its switched access rates to mirror January 1, 1999 interstate rates and structure. This is a reduction of \$378,000. In addition, CCL rates should be reduced to reflect the net difference between the reduction to mirror interstate CCL rates and the increase to mirror interstate PICC rates. This is a net reduction of approximately \$232,000.

Touch Tone Rates. CBT proposed to eliminate its touch tone rate element and offer touch tone service generally to all subscribers. This would include touch tone within the subscriber's basic rate. Not all subscribers currently subscribe to touch tone. Such a change would place an undue burden on customers not currently subscribing to

touch tone service. Therefore, the Commission requires that CBT provide a credit of \$.75 per month to those subscribers not currently taking touch tone service. This results in a reduction of \$115,000 annually.

Band 3 Rates. CBT generally proposed that the three northern Kentucky counties be divided into two rate bands: one for the Kentucky metro area and a second band for the remainder. As discussed earlier, the Commission adopts this concept, but in an attempt to retain rate uniformity and reduce rates to levels required by the revenue sufficiency, the Commission finds it necessary to collapse Band 3 into Band 1. This results in a revenue reduction of \$944,000.

Band 4 Rates. CBT proposed to increase Band 4 rates. In particular, CBT proposed to increase the rates of its optional EAS offering. CBT first offered this service in November 1995 to allow those customers an option to make toll-free calls to other CBT exchanges. This service continues to expand, and in retrospect to the prior Order, finds it appropriate to lower the rates slightly to \$26.00 for basic service. This results in a reduction of \$354,000.

Hunting

CBT proposed to restructure its hunting rates by specifically developing a new rate element of \$11.00 per month in order to achieve the prescribed revenue sufficiency. The rate for hunting has been decreased to \$9.50. This results in a reduction of approximately \$192,000.

The Commission, having considered the evidence and having been otherwise sufficiently advised, HEREBY ORDERS that:

1. The alternative regulation plan proposed by CBT, as modified by stipulations with the AG and AT&T, is hereby approved, except as specifically noted herein.

2. The stipulation entered between the AG and CBT is approved.

3. The stipulation entered between AT&T and CBT is not explicitly approved as noted herein.

4. CBT may not carry forward unused increases in its alternative regulation plan.

5. The recovery of exogenous costs as proposed by CBT is denied.

6. CBT shall establish a procedure to share its earnings with its ratepayers as described herein.

7. There shall be an informal conference on March 16, 1999, at 10:00 a.m. in Conference Room 1 of the Commission's offices at 730 Schenkel Lane, Frankfort, Kentucky, to address the details of the sharing mechanism adopted herein.

8. Within 30 days of the date of this Order, CBT shall file a separate tariff section containing the cell structures, rates, terms and conditions of service, and duration of its alternative regulation plan, including its access charges. The tariff shall also include CBT's proposed mechanism for its earnings sharing procedure.

9. The rates proposed by CBT, except as noted herein or otherwise modified, are hereby approved.

10. Within 30 days of the date of this Order, CBT shall file revised tariffs reflecting its proposed changes and incorporating the modifications herein, effective with the date of this Order.

Done at Frankfort, Kentucky, this 25th day of January, 1999.

By the Commission

ATTEST:

Executive Director