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 CHARGES AND TO CHANGE REGULATIONS AND PRACTICES AFFECTING SAME	)))))	CASE NO. 98-292

O R D E R

On March 4, 1999, the Commission granted the petition for rehearing of Cincinnati Bell Telephone Company ("CBT") on the issue of the earnings sharing mechanism to determine the impact on CBT and its customers of such mechanism and to consider possible alternatives. Rehearing was also granted to determine the appropriate level of restructuring expense and to provide CBT with an opportunity to propose reductions to rate elements different from those contained in the January 25, 1999 Order.

CBT filed testimony on these rehearing issues. No intervenors filed testimony or opposed CBT's requests. Tri-County Economic Development Corporation ("Tri-ED") petitioned to intervene on April 16, 1999. The Commission granted its petition. Tri-ED supports CBT's views.

EARNINGS SHARING MECHANISM

CBT's alternative regulation plan lacked a productivity factor. The Commission determined in its January 25, 1999 Order that some measure of productivity should be derived through an earnings sharing mechanism. However, CBT asserts on rehearing that the sharing mechanism jeopardizes its future enhancements to the local network and its efforts to adjust rates toward costs. CBT asserts that earnings sharing "dilutes the incentives to reduce costs, expand output and invest in new infrastructure and new technology; distorts pricing decisions for all the company's regulated services, irrespective of service costs, current prices and competitive market conditions; maintains theoretical incentives to mis-allocate costs and subsidize competitive services; and continues to impose regulatory costs and inefficiencies."[1] Moreover, CBT argues that inflation, coupled with the freeze on residential rates, acts as an implicit productivity factor and is sufficient.

In its rehearing testimony, CBT proposed six alternatives to the sharing mechanism.[2] CBT contends that none of the alternatives is in the public interest; however, it asserts that one alternative may be appropriate: adoption of a three-year rate freeze as contained in the stipulation with the Attorney General's Office of Rate Intervention. It must be noted that this portion of the stipulation was not modified by the Commission in its previous Order and has been in effect since the January 25, 1999 Order. CBT should file a tariff to reflect this residential rate freeze.

The Commission has reviewed the rehearing testimony and finds that the earnings sharing mechanism should be deleted from CBT's alternative regulation plan. Upon further consideration, the Commission finds that the combination of CBT's alternative regulation plan with the earnings sharing mechanism imposed by the

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[1] Rehearing testimony of Dr. William E. Taylor at 2.

[2] Rehearing testimony of Donald I. Marshall at 11.

Commission mixes regulatory formats in a manner that distorts the intended incentives to the utility and its customers.

Under CBT's alternative regulation plan, which is essentially a price-cap plan, earnings are not of primary importance. This regulatory format is a precursor to company-wide, full-market competition. It is designed to give CBT a degree of pricing freedom, depending upon the amount of competition experienced from other carriers for similar services. Under a price-cap plan, a utility is allowed to earn a market return on competitive services because the presence of competitive choices should work to prevent excessive pricing.

Accordingly, the Commission finds that inflation will be an appropriate implicit productivity factor for CBT's alternative regulation plan. The threat of impending local competition is the market dynamic that will continuously drive efficiency gains and a rational pricing structure for CBT. CBT operates in a three-state area. Its competitive pricing strategies implemented in Ohio, its largest market, directly affect its Kentucky market.

Moreover, though CBT is given broad pricing latitude in its alternative regulation plan, it is prohibited by law from pricing its services below cost unless it is matching a competitor's price. CBT must maintain its prices above the long run incremental cost of the related services except when it is responding to a competitor's pricing challenge. As the Commission has previously determined, pricing below the long run incremental cost of a service is not predatory pricing where it is done solely to meet a pricing challenge from a competitor.[3] When filing tariffs with this pricing exception, CBT must provide cost studies and evidence that competitors have already charged rates below those which could cover its long run incremental costs. If a competitive price threat subsides, CBT must, within 30 days, restore its price to cover its long run incremental cost.

QUARTERLY REPORTS

In order that the Commission may continually monitor the effects of CBT's alternative regulation plan, it will require CBT to provide quarterly financial reports. These reports will consist of an actual 12-month-to-date Kentucky jurisdictional income statement in substantially the same form as is now provided as Schedule 1 of CBT's current quarterly reports, a rate base summary schedule in substantially the same form as is now provided on Schedule 2 of CBT's quarterly financial reports, and a schedule showing Kentucky jurisdictional capital in substantially the same form as is now provided on Schedule 4 of the company's quarterly financial reports. The income statement must be adjusted for the after-tax effect of the following items: (1) directory imputation of $2.6 million, (2) Kentucky interest during construction, (3) Kentucky employee concession service, and (4) any jurisdictional out-of-period or non-recurring individual expense in excess of $100,000. The rate base schedule must include only those components found appropriate in this proceeding.

If the quarterly reports show substantial increases in CBT's earnings, the Commission may revisit the issue of a sharing mechanism as a substitute for a productivity factor or other related matters.

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[3] Case No. 94-121, Application of BellSouth Telecommunications, Inc. d/b/a South Central Bell Telephone Company to Modify Its Method of Regulation, July 20, 1995 Order at 23-25.

RESTRUCTURING CHARGES

When CBT filed its case in June 1998, an adjustment was made to recognize a restructuring charge and credits to expenses for settlement gains associated with pension expense. These two adjustments resulted in an increase to expenses of $10.3 million on a total-company basis. Subsequently, CBT filed detailed expense adjustments for individual accounts. In doing so, only the months in which the above adjustments created a credit balance in the expense account were adjusted. This adjustment totaled $15.8 million on a total-company basis. Annualization of expenses based upon the $15.8 million amount resulted in an expense decrease of $241,000 on an annual jurisdictional basis.

On April 5, 1999, CBT filed its rehearing testimony, which included all months affected by the restructuring charge and settlement gains. As a result, the expense adjustment changed to an increase in expenses of $523,000 on an annual jurisdictional basis. This change increased expenses and decreased the revenue sufficiency by approximately $764,000.

The Commission agrees with CBT's revised restructuring charge and settlement gains and finds that the revenue sufficiency should be reduced from $3.061 million to $2.297 million.

RATE DESIGN ISSUES

On April 23, 1999, the Commission entered an Order granting interim approval to the tariffs filed by CBT on February 23, 1999, March 12, 1999, and March 25, 1999, pending determination of CBT's petition for rehearing, and rates were subject to refund retroactive to the original effective date of January 25, 1999. The proposed tariff dated

February 23, 1999 did not address future access charge changes, reduction of Band 4 rates, the hunting charge rate, or switched access rate changes. CBT said it would amend the tariffs upon the Commission's decision.

As discussed earlier, the revenue sufficiency has been reduced to $2.297 million. CBT submitted a schedule of rate design changes approximating this revised revenue requirement.[4] In this schedule, CBT proposed to re-establish the Band 3 rate as originally filed and to eliminate selected non-recurring charges for non-residence services.

The Commission accepted the April 5, 1999 proposal. Thus, CBT must revise its tariff to fully implement any unchanged rates established by the January 25, 1999 Order that were not included in the February 23, 1999 tariff. CBT must also file a plan to refund the over-collections for Band 4 rates, hunting, TouchTone, switched access, the common line charge, and other over-collections in rates. The plan must show the amounts of all over-collections and the method of credit or refund for each service.

The Commission, having considered the issues on rehearing and having been otherwise sufficiently advised, HEREBY ORDERS that:

1. The earnings sharing mechanism shall be deleted from CBT's alternative regulation plan.

2. As specified in the stipulation with the Attorney General, approved with modifications by the Commission in its January 25, 1999 Order, there is a three-year rate freeze for residential rates.

[4] Rehearing testimony of Robert W. Wilhelm, Schedule 1.

3. Within 20 days of the date of this Order, CBT shall file a tariff reflecting the three-year residential rate freeze specified in its stipulation with the Attorney General.

4. CBT may price its services below its long run incremental cost only if it is matching a competitor's price.

5. When CBT files a rate which is below the long run incremental cost of the service, it shall provide cost studies and evidence that competitors have already charged rates below those which would cover CBT's long run incremental cost. Once the pricing threat subsides, CBT shall restore its price to cover its long run incremental cost.

6. CBT shall file quarterly reports as specified herein.

7. CBT's revenue sufficiency is reduced from $3.061 million to $2.297 million.

8. CBT's proposal for rate design shall be accepted.

9. CBT shall revise its tariff to implement rates not yet changed as ordered by the January 25, 1999 Order.

10. Within 20 days of the date of this Order, CBT shall file a plan to refund its over-collections for Band 4 rates, hunting, TouchTone, switched access, common line charge, and any other over-collections as specified herein.

Done at Frankfort, Kentucky, this 26th day of July, 1999.

By the Commission

ATTEST:

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Executive Director