ORDER NO. 00-191

ENTERED APR 14, 2000

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UT 125/UT 80

In the Matter of the Application of U S WEST Communications, Inc., for an Increase in Revenues.	)))	ORDER

DISPOSITION: PORTIONS OF ORDER NOS. 96-183 AND 97-171 READOPTED

This is a companion order to Order No. 00-190, entered this date. In that order, among other things, we rescinded Order Nos. 96-183 and 97-171 in compliance with the Stipulation, which we adopted as modified. In the current order, we readopt portions of those orders. The readopted portions either explain methodology or are unaltered by the Stipulation. This readopting order should be read in conjunction with Order No. 00-190 for an understanding of all modifications to Order No. 97-171. Appendix B to Order No. 00-190, Results of Operations, gives a synthetic overview of the effect of all changes to and readoptions of Order No. 97-171.

In summary form, we set out below modifications to and readoptions of Order No. 97-171, as a result of adopting the Stipulation in Order No. 00-190.

a) Issue 1, Test Year, pages 8-20, is readopted.
b) Issue 1b, Net to Gross Factors:
- The discussion on page 9 of Order No. 97-171 is readopted.
- The stipulated factors are weighted based on the revenue distributions used in settlement of Issue 11, Refund Procedures.
- The factors shown in Order No. 97-171, Appendix A, page 21, are readopted.
- The weighted net to gross factors from Appendix B, Lambeth/2, Column 4, of Order No. 00-190 are added.

c) Issue 2, Cost of Capital, the discussion on pages 20-37 of Order No. 97-171 is readopted.
d) Issue 3a, U S WEST Direct Yellow Pages Revenue Imputation (*see* Order No. 00-190, Appendix B, Column 16), the discussion on pages 37-43 is readopted *except:*
- USWC may continue to use the retention rate from UT 102, in effect since June 1992; and
- Foreign directory revenues are removed from the imputation.

e) Issue 3b, U S WEST Direct Yellow Pages Revenue Growth, the discussion on page 43 is readopted, but the amount in Appendix A, Column 16a, is amended to reflect the $0.3 million reduction in growth due to exclusion of foreign directory revenues and the change in retention rate. *See* Order No. 00-190, Appendix B, Column 16a.
f) Issue 4, Affiliated Interests and Corporate Allocations, the Issue 4 adjustments at pages 44-59 are readopted.
g) Issue 5, UP 96 Sale of Exchanges, the Issue 5 discussion at pages 59-62 is readopted.
h) Issue 6, Operating Revenues, the discussion at pages 62-68 is readopted.
i) Issue 7, Employee Benefits, the discussion at pages 68-72 is readopted.
j) Issue 8, Operating Expenses and Taxes, the discussion at pages 72-83 is readopted except as modified with respect to Issue 8f and Issue 8n. Issue 8o is added as shown in Order No. 00-190, Appendix B, Column 59. *See* Order No. 00-190, Appendix A, Paragraph 12.

- Issue 8f, ORS 291.349 Income Tax Refund: Staff modified adjustments at Issues 3 and 9 that affected taxable income. The Issue 8f discussion at pages 72-73 is readopted, but the amounts in Column 42 of Appendix A to Order No. 97-171 are amended as shown in Order No. 00-190, Appendix B, Column 42.
- Issue 8n, PUC Fee Increase: The discussion at page 83 is readopted, but the amounts in Appendix A, Column 49a, of Order No. 97-171 are amended as shown in Order No. 00-190, Appendix B, Column 50.

k) Issue 9, Service Quality and Reengineering:

- The findings regarding Issue 9a and 9b at pages 83-93 are readopted. In Order No. 97-171, Appendix A, the revenue requirement consequences of these issues are shown in Columns 50 and 51. In Order No. 00-190, Appendix B, they are shown in Columns 51 and 52.
- Issue 9c, Service Quality: Staff added Issue 9d, New Plant Investments and Related Costs, for settlement purposes. That addition changed the revenue requirement of Issue 9c. The discussion at pages 93-101 of Order No. 97-171 is readopted, but the amount shown in Appendix A, Column 52, of Order No. 97-171 is amended to include the Issue 9d effects on the service quality adjustment. The new amount is shown in Order No. 00-190, Appendix B, Column 53.
- Issue 9d, New Plant Investments and Related Costs: Staff added rate base and related expenses to recognize investment made from May 1996 through December 1998, as shown in Column 54, Appendix B to Order No. 00-190.

l) Issue 10, Final Test Year Separation Factors: Staff modified adjustments at Issues 3a, 3b, and 9d for settlement purposes. Staff calculated the intrastate effects of each adjustment on the final separation factors. The discussion at page 101 of Order No. 97-171 is readopted, but the amounts shown in Appendix A, Column 53 of that order are amended as shown in Order No. 00-190, Appendix B, Column 56.
m) Issue 11, Refund Procedures: The discussion at pages 101 to 107 is readopted except: 1) the interest rate is revised; 2) the refund eligibility date is updated from May 19, 1997, to reflect the provisions of the Stipulation, Appendix A to this order, starting at 3; 3) we update the date when the refund will begin, in accordance with the Stipulation, *supra*; 4) we allow a refund for former

customers; and 5) we allow temporary rate reductions and bill credits as provided in the Stipulation.

- Issue 11a, Amount of Refund: We revise the conclusions to allow refunds to be based on an amount lower than the adjusted test year revenue requirement.
- Issue 11b, Interest Rate for Refund: The interest rate for the refund shall be 8.77 percent.
- Issue 11c, Distribution of Refund: We update the refund eligibility date from May 19, 1997, to be consistent with the Stipulation, Order No. 00-190, Appendix A, Paragraph 1.

n) Issue 12, Cash Flow; Issue 13, Business Valuation: These issues were combined in Order No. 97-171 at pages 107-113. The issues were part of USWC's argument that Staff's proposed revenue requirement was unreasonable. Because USWC agreed to a revenue requirement in the Stipulation, these issues are moot and are not readopted.

o) Issue 14, Effect of UM 351 on access revenues: The discussion on page 114 is readopted.

p) Ordering Paragraph 4f, at page 115 of Order No. 97-171: Distribution of the Refund: This paragraph is readopted.

ORDER

IT IS ORDERED that:

1. Portions of Order No. 96-183 are readopted, as set out below.

Order No. 96-183. This order clarifies the refund procedures for potential overearning during the period in which rates were interim following termination of the Alternative Form of Regulation plan. As a result of the Stipulation adopted in Order No. 00-190, the Resolution, Conclusion, and Order sections of this order are not readopted. However, we do readopt the Introduction, and Discussion sections of the order from pages 1-3 of the original Order, as set out below:

Introduction

In response to reduced service quality by U S WEST Communications, Inc., (USWC), this Commission recently terminated the company's alternative form of regulation (AFOR) plan authorized in Order No. 91-1598. USWC subsequently filed this Petition for Clarification and Request for Ruling concerning the interpretation of Order No. 91-1598 with respect to the "procedures to be followed or the rates to be charged by USWC in the event the [AFOR] is terminated prematurely[.]" USWC contends that, in determining whether a refund is warranted, we must review the company's actual earnings for the period during which interim rates were in effect.

Staff filed a reply to USWC’s petition and disputes the company’s interpretation of the refund provisions. It contends that the January 1 to September 30, 1995, annualized test year, as modified by adjustments ordered in pending docket UT 125, should be used to determine if the company overearned during the interim rate period. On July 11, 1996, USWC filed a response to Staff’s reply.

Discussion

In November 1991, the Commission offered USWC an AFOR plan under terms and conditions set forth in Order No. 91-1598. USWC accepted the offer, and the AFOR was implemented effective January 1, 1992.

Among other things, Order No. 91-1598 contained the method for determining the amount of refund by USWC upon a premature termination of the AFOR. The relevant language in that order provides:

> The Commission finds that the [AFOR] stipulation should be modified to include a provision which protects USWC and its customers in the event the Plan is terminated prematurely due to one of the [specified conditions.] We propose that Paragraph 10 should be amended to include the following language[:]
>
> * * * * *
>
> (2) If the Commission declares the plan terminated, it may also order USWC to refrain from making any further changes in rates or terms of price listed services. * * * The Commission may also initiate an investigation to determine the rates and terms of service which should be placed in effect on a permanent basis.
>
> (3) Unless otherwise ordered by the Commission, rates authorized under (2) of this subparagraph after the plan has been terminated shall be considered interim rates subject to refund. The amount subject to

> refund with interest shall be that portion of USWC's earnings which the Commission finds have exceeded a reasonable rate of return, commencing with the date of the order terminating the plan and ending with the date that permanent rates are set and are in effect. For purposes of determining the amount of the refund, the Commission shall not be bound by the provisions of this paragraph or any other provision of the Plan.

* * * * *

The amendments proposed by the Commission are intended to remove any uncertainty regarding the procedures to be followed in the event the Plan is prematurely modified or terminated. The changes will also prevent USWC from over or under earning while proceedings are held to establish new permanent rates. To clarify: Subparagraph (2) provides that the Commission may freeze the rates charged by USWC at the levels in effect on the date the plan is terminated. The Commission would likely choose this option if the Plan is terminated because USWC's earnings have exceeded the upper limits established in the Plan. * * * Lastly, subparagraph (2) permits the Commission to initiate a separate proceeding to determine the permanent rates to be charged.

Subparagraph (3) specifies that the rates in effect from the date the plan is terminated until the date new permanent rates are set shall be interim rates subject to refund. A refund will take place only where USWC has been determined to have been overearning. *The amount of any refund will equal the difference between the amount USWC is actually earning and the amount subsequently found to be reasonable*. Any refunds will accrue interest at USWC's authorized rate of return on rate base.

Order No. 91-1598 at 27-29 (footnote omitted) (emphasis added).

Relying on the italicized language, USWC contends that, now that the AFOR has been terminated, our refund determination must be based on an examination of the company's actual earnings during the period rates are interim. Comparing the process to a true-up of base earnings in an application for deferral under ORS 759.200(4), it argues that earnings cannot be adjusted for disallowances imposed retroactively, for annualization of intra-period events, or normalization adjustments for nonrecurring and unusual events.

Staff disputes USWC's assertions and presents a different interpretation of the language cited above. It contends that the amount subject to refund is equal to the difference between the permanent rate level established by the Commission and the current, interim rate level, assuming that the latter amount of revenues is greater than the former. It argues that the Commission used the term "interim rates" to refer to the commonly understood method of refund determination used in ORS 757.215(4) and 759.185(4).

2. Portions of Order No. 97-171 are readopted, as set out below.

Order No. 97-171. This is the order in which the Commission determined the revenue requirement for USWC. Appendix A to this order, Results of Operations, is based on Appendix A to Order No. 97-171. References to Adjustments by number are to this Appendix. Figures or notes that have changed in Appendix A to Order No. 97-171 have been blanked out in Appendix A to this order. For a summary of the effects of readoption and of portions of Order No. 97-171 and the modifications to the conclusions of that order mandated by the Stipulation adopted in Order No. 00-190, *see* Appendix B to Order No. 00-190.

Appendix B to this order is the same Appendix B as to Order No. 97-171, the First Stipulation. Appendix C, and Appendix D are also the same as the same designated appendices to Order No. 97-171. Appendix E is not readopted.

Issue 1. Test Year. The discussion at pp. 8-20 of Order No. 97-171 is readopted.

ISSUE 1: TEST YEAR

Completely Settled Issues:

- *Issue 1a(2), Annualization Methods (Adjustment 1).* Staff and USWC agree to start with total Oregon data recorded during the 9 months ending September 30, 1995, and add annualizing adjustments, to estimate the last 3 months. *See* Appendix B, First Stipulation, Paragraph 1a.

- *Issue 1b, Net to Gross Factors.* Staff and USWC agree to use the revenue sensitive factors shown in Staff Exhibit 3, Lambeth 4, Columns d-f. *See* Appendix B, First Stipulation, Paragraph 1b.

- *Issues 1c-m(1), Side Records and Annualizations (Adjustments 2-13)*. Except for USWC's inclusion of costs related to switching assets that are no longer in service (Issue 1m(2)), Staff and USWC agree on the annualization of side records, revenues, expenses, and rate base. *See* Appendix B, First Stipulation, Paragraph 1a.

- *Issue 1n, Separations.* Staff and USWC agree on the intrastate factors to apply to the base period and adjustments. However, Staff and USWC disagree about the underlying expenses, rate base, and taxes used to compute the final factors (Issue 10). *See* Appendix B, First Stipulation, Paragraphs 1a, 25.

Disputed Issues:

- *Issue 1a(1): Test Year.* The Commission "normally establishes utility rates prospectively based upon a test year reflecting the restated and normalized operating results during such period. The test year may be adjusted for abnormal or nonrecurring items and for known changes occurring after the test period" (Order No. 77-125). Staff and USWC agree that "the purpose of a test year is to be representative of the period in which rates will be in effect." *See* Revised Staff Exhibit 1, Lambeth 17-19; USWC Exhibit 1, Inouye 15.

Staff attempted to determine on a going forward basis the amount of revenue and the rate levels that are necessary to provide USWC with the opportunity to earn a fair return on its investment. Staff believes that USWC's adjustments to the annualized test year are not sufficient to represent the period when rates from this docket will be in effect. USWC has made adjustments only for some events that will have occurred by the time rates become effective (May 1, 1996). Staff used the 32 month period from May 1, 1996, to December 31, 1998, to represent the period when rates from this docket will be in effect. Rates became effective on May 1, 1996, and Staff assumes that USWC will file a new rate case in time for new rates to become effective January 1, 1999.

Staff maintains that the purpose of a rate case, whether it uses a historic or a future test year, is to determine whether the reported results of operations are reasonably representative of future operating conditions. USWC contends that use of a historic test year presumes that the past represents the future. USWC also argues that forecasting methods are so complicated and uncertain that forecast adjustments should not be applied to historic data. In past orders, the Commission has disagreed with USWC's argument.

USWC disagrees with Staff's test year and claims that Staff has inappropriately adjusted for changes in operations that will occur (or have occurred) after December 31, 1995. The primary disputes are about pro forma adjustments (including forecasts and other estimates) and normalizing adjustments, which develop or restore normal recurring cost and revenue relationships representative of the period when rates from this docket will be in effect. Normalizing adjustments also remove unusual events, which Staff believes USWC's reengineering program is.

- *Issue 1m(2), Switching Assets (Adjustment 14a).* Staff disagrees with the inclusion of costs related to switching assets that are no longer in service.

Issue 1a(1): Test Year

A fundamental issue in this case is how the test year should be constructed. In *Pacific Northwest Bell Telephone Company*, UT 43, Order No. 87-406 at 11-12, we set out the purpose and characteristics of the test year in ratemaking:

> The starting point for setting rates is either the results of operations for a historical 12 month period or forecasted results of operations for a future period. The period chosen is called a "test year."
>
> Results of operations are useful only as a starting point because they normally include (1) expenses that will not be incurred in the future, and (2) revenues that will not be realized in the future. Since the utility can be expected to overearn if nonrecurring expenses are covered by the recurring revenues resulting from a rate increase, nonrecurring expenses are eliminated from consideration. To avoid underearnings, nonrecurring revenues also are excluded.
>
> Ratemaking is done on a prospective basis. Therefore, recurring increases in revenues and expenses that are reasonably certain to occur are added to the test year.
>
> Another common adjustment in development of the test year is annualization of recurring revenues or expenses that begin partway through the 12 month period. An

> example would be a new wage contract that takes place in July of a January to December test year. By annualizing the wage increase, the test year will reflect that the higher wages will be in effect for the entire 12 months of a future year.

USWC and Staff agree that the purpose of a test year is to represent the period in which rates will be in effect. They agreed to use historic data as a starting point for development of the test year for this proceeding. They agreed that their starting point should be USWC's recorded results of operations for the nine months ended September 30, 1995. They further agreed that the last three months of 1995 should be estimated and added to the nine months of data to obtain an annualized test year.

Staff and USWC disagree, however, about the adjustments that should be made to the annualized test year to make it representative of future operations. The adjustments USWC proposes would increase its revenue requirement by approximately $23 million; Staff's adjustments would decrease USWC's revenue requirement by approximately $100 million.

Adjustments to the Test Year. USWC has largely limited its test year adjustments to events that occurred on or before January 1, 1996, the effective date for the new rates. Staff's position is that USWC's proposed adjustments are not sufficient to make the annualized test year representative of the period during which rates will be in effect.[1] Specifically, Staff believes that:

- USWC's future revenues will be significantly higher than USWC claims. See, e.g., Issues 3a and 3b (Yellow Pages imputation and growth), 6c (price and contract changes since January 1, 1995), and 8j (access line growth). These Staff adjustments account for $57 million of the difference between Staff's and USWC's revenue requirement estimates.

- USWC's recurring expenses will be less than USWC claims. This bears particularly on Issues 9a and 9b, reengineering and extraordinary expenses, which account for $32 million of the difference between Staff's and USWC's estimated revenue requirement.

Staff has recommended both pro forma and normalizing adjustments to the test year. Pro forma adjustments restate the test year to include the effects of changes that have occurred or are reasonably certain to occur after the test year.[2] Directory revenue growth (Issue 3b) and access line growth (Issue 8j) are examples of pro forma adjustments. Normalizing adjustments develop or restore normal recurring cost and revenue relationships representative of the period when rates from this docket will be in

[1] Staff used the 32-month period from May 1, 1996, through December 31, 1998, for the period during which rates from this proceeding would be in effect. USWC’s rates became interim rates subject to refund on May 1, 1996, when the Commission terminated USWC’s Alternative Form of Regulation (AFOR) plan by Order No. 96-107. May 1, 1996, is therefore the effective date for rates from this proceeding. Because USWC has opposed many of the revenue requirement recommendations Staff has made in this proceeding, Staff assumes that USWC will file for new rates to be effective no later than January 1, 1999.

[2] ***See*** Order No. 87-406 at 11.

effect. In Issue 7e, for instance, Staff removed part of an accrual that will end soon after rates in this proceeding go into effect. Some of Staff's adjustments are for events that happened after the historic test period (January 1 to September 30, 1995). That is the case with Issue 6c, where Staff annualized the effects of tariff, price, and contract revisions USWC has made since January 1995.[3]

USWC opposes Staff's pro forma and normalizing adjustments. USWC argues that it and Staff agreed to a 1995 test year, and contends that Staff has improperly made projections to August 1997. USWC argues that the Commission should largely ignore changes in its operations that occur after the end of the historic test year (December 31, 1996). For instance, USWC objects to Staff's adjustment for tariff increase effects (Issue 6c).

USWC also objects to adjustments based on forecasts, claiming that the Commission does not use forecasted test years or forecasts for adjustments to historic test year data. For this reason, USWC objects, for instance, to test year adjustments to reflect revenues from access line growth (Issue 8j), what Staff contends are nonrecurring expenses related to reengineering (Issues 9a and 9b), and cost savings from new information management systems (Issue 8l).
USWC argues that adjustments to test year data are permitted only under limited circumstances: "to remove abnormal events not expected to recur and . . . to include the effect of known changes in data which are expected to persist into the future." *Portland General Electric*, UF 3518, Order No. 80-021 at 24. In USWC's view, use of recent historic test year data provides the most

[3] Disputed pro forma adjustments include: Issue 3b, U S WEST Directory Growth; Issue 4d2, Fax Services Growth; Issue 7a2, SFAS 106 Postretirement Benefits; Issue 8b2, Other Payroll Changes; Issue 8j, Average Growth in Access Lines; and Issue 8n, PUC Fee.

Disputed normalizing adjustments include: Issue 4dl, Fax Services; Issue 5a, UP 96 Sale of Exchanges; Issue 6c, tariff, Price, and Contract Changes; Issue 8l, Information management systems; Issue 91, Service Reengineering Costs; and Issue 9b, Extraordinary Expenses.

accurate means of estimating a utility's operations.

USWC proposes that adjustments may be made to the test year only (1) to annualize the effects of specific events that occur during the test year and (2) for known changes that occur after the test year, but whose effects are reasonably measurable. USWC maintains that the first type of adjustment should be made only for items that are not linked, logically and economically, with other revenues, expenses, or investments. That caveat serves to minimize interdependencies and to maintain the match among revenues, expenses, and investments in the test year. USWC takes the second category of adjustment to preclude adjustments based on forecasting.

USWC also challenges Staff's proposed disallowance of certain expenses (for instance, Issue 8a, Bonuses; Issue 4a and 4b, Lease Rates; Issue 5a, UP 96 Sale of Exchanges). USWC argues that the Commission may not disallow actually incurred expenses unless they were imprudently incurred, and no allegation of imprudence was made with respect to these expenses.

Staff points out that USWC has been inconsistent in its position. USWC proposed adjustments to the test year to include an adjustment for increased depreciation expense (Issue 8g).[4] Staff argues that this adjustment reflects shortened asset service life projections and resulting higher depreciation rates, based on forecasts of future changes in telecommunications technology. Staff argues that USWC also wishes to include an adjustment for the future adverse effects of the orders in Commission docket UM 351 (Issue 14).

Staff also takes issue with USWC's contention that this Commission does not use forecasted test years or forecasts for adjustments to historic test year data. Staff points out that through the late 1970s and early 1980s, when the per unit cost of electricity was rising, the Commission used present or future test periods rather than

[4] Staff agreed to this adjustment, which reflects the results of docket UM 767. See Appendix B, First Stipulation, Paragraph 21.

historic test periods, and forecast adjustments to the test year to prevent the utility from underearning during the period in which rates were to be in effect.[5] Staff argues that USWC is in the opposite position. That is, USWC is facing increasing revenues and stable or decreasing ongoing expenses per access line. Staff believes this fact explains why USWC urges the Commission to rely on historic data and make few adjustments for the future.

Disposition. The purpose of a test year is to provide a basis for determining a utility's revenue requirement. All test years are estimates of future conditions for the utility. When, as here, the test year is based on an historical period, that period is merely a starting point for determination of the revenue requirement. The Commission must ensure that the historical period is reasonably representative of the period during which rates will be in effect. The point is to prevent overearning or underearning during that period.

USWC challenges many of Staff's normalizing adjustments on grounds that they may distort the relationship among investments, revenues, and expenses. We have reviewed each of Staff's proposed normalizing adjustments, issue by issue, and disagree with USWC. We find that Staff has been careful to match investments, revenues, and expenses for its proposed adjustments. We will deal with these arguments as they arise in the context of the individual issues.

USWC challenges many of Staff's pro forma adjustments because they are based on forecasts. USWC sets up a "known and measurable" standard for adjustments to the test year data for future events, and argues that that standard precludes use of forecasted adjustments. We disagree. The standard USWC proposes for pro forma adjustments is more restrictive than the one we set forth in *Pacific Northwest Bell*, UT 43, Order No. 87-406. In that case we stated that because ratemaking is prospective, "recurring increases in revenues and

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[5] Staff cites to *Portland General Electric Co.*, Order No. 77-776 at 7; *Portland General Electric Co.*, UF 3218, Order No. 76-601 at 4, 8.

expenses that are reasonably certain to occur are added to the test year." *Id.* at 11. The "reasonably certain" standard, rather than the "known and measurable" standard, is the correct one for judging whether a given adjustment is appropriate. That standard does not preclude forecasts. We use the same standard to exclude nonrecurring revenues and expenses. We have reviewed each of Staff's proposed pro forma adjustments under this standard. Moreover, we note that USWC has proposed forecasted adjustments of its own: the proposed depreciation expense adjustment and the adjustment for the future adverse effects of the orders in Commission docket UM 351.

Finally, USWC argues that actually incurred expenses may not be disallowed absent a finding of imprudence. We disagree. As we stated above, in the section called "USWC's Burden of Proof Argument," USWC must show that its expenses are reasonable for us to allow them as part of the revenue requirement calculation.

Reasonableness of Staff's Adjusted Test Year. USWC contends that Staff's test year adjustments are improper because the results of Staff's adjustments are unreasonable. USWC supports its argument with reference to its calculation of Oregon revenue and expense per access line. USWC submits Exhibits 156 (revenues) and 157 (expenses), which graph revenues and expenses per access line from 1992 through 1995 and show Staff's 1997 projections. USWC's calculations on Exhibit 156 show actual revenues in 1995 of $285, while Staff's calculation of revenue per access line for 1997 is just under $300. USWC Exhibit 157 shows 1995 expense per access line at approximately $233, while Staff shows 1997 expense per access line at about $204. According to USWC, the disparity between its calculations and Staff's demonstrates that Staff's results are unreasonable.

Staff responds that USWC's exhibits are based on unanalyzed recorded results of operations, whereas Staff's results are based on analyzed and adjusted test year results. Moreover, Staff argues that USWC's actual 1995 Oregon revenue per access line figure reflects only $34.8 million of U S WEST Direct's Oregon directory revenues, while Staff's 1997 figure reflects $57.8 million in directory revenues, the sum of Staff's recommended adjustments in Issue 3a and 3b.

Further, Staff argues that its results are reasonable because the difference between USWC's actual Oregon revenue per access line in 1995 and Staff's estimate for 1997 as depicted on USWC Exhibit 156 is less than 6%. That equates to an average revenue growth of less than 3% per year for 1996 and 1997. Staff argues that U S WEST Direct's Oregon directory revenues are increasing by 7% or more per year, and USWC's local service revenues are increasing by 7 to 9.5% per year. USWC access lines are increasing by 3 to 5 % per year, so Staff concludes that USWC's revenue per access line is increasing several percent per year. Therefore, Staff contends, Staff's adjusted test year revenues for USWC are reasonable.

As to expenses, Staff again argues that its results are analyzed and adjusted, whereas the USWC figures have not been analyzed, normalized, or adjusted for reasonably certain future changes. Moreover, Staff contends, the recorded expense figures on which USWC relies are subject to change from events such as accounting changes or changes in separation factors.

Staff prepared two exhibits to clarify the pattern of expense growth. Based on evidence in the record, Staff produced Appendices B and C to its opening brief. Appendix B shows recorded and adjusted test year expense per line on the same basis as USWC Exhibit 157, but unlike USWC Exhibit 157, Appendix B provides the recorded results for 1989 through 1991 and sets the origin to zero. Appendix C to Staff's brief shows the recorded and adjusted test year expense in total rather than on a per access line basis. Appendix C shows comparable expense levels from 1989 to 1991, a spike in expenses in 1992, perhaps associated with the change in accounting for retirement benefits, and comparable results for 1992, 1993, and the test period.

Staff contends that its Appendices B and C show relatively flat expense growth over time except for a spike in 1992 and higher expenses in 1994 and 1995, the period with nonrecurring reengineering expenses and extraordinary expenses.

USWC claims that some of Staff's adjustments double count and overlap. Staff responds that it held many meetings to coordinate its review of USWC's case and that it made adjustments wherever it discovered errors in its calculations. Staff asserts that USWC's claim is without merit.

USWC also claims that Staff did not take into account increased expenses related to some of its revenue adjustments. Staff contends that USWC has not presented persuasive evidence to support these claims.

***Disposition*.** We conclude that the results of Staff's adjusted test year and USWC's calculations on Exhibits 156 are not inconsistent, given the growth rates in directory revenues and in access lines. Staff's growth rate assumptions are conservative compared to the increases in Oregon directory revenues and local service revenues that Staff cites. Staff's explanation of the difference between its calculations and USWC's is persuasive.

We are also persuaded by Staff's explanation of the difference between its expense projections and USWC's recorded expenses. USWC's Exhibit 157 includes nonrecurring reengineering and extraordinary expenses in the test period (see discussion at Issue 9 below). Staff has normalized and adjusted expenses to arrive at its projection. We conclude that the disparity between revenue and expense figures that USWC presents in Exhibits 156 and 157 does not prove that Staff's case is unreasonable.

As to USWC's argument that Staff has double counted or allowed overlaps of expenses, we note that Staff has amended its testimony where errors have been pointed out to it. We also note that USWC alleges double counting with respect to Issues 6c and 8j, but that is based on a misunderstanding of Issue 8j. See discussion of that issue below. We are persuaded by Staff's defense of its calculations.

Issue 1m(2): Switching Assets

The step by step and crossbar equipment under discussion in this issue are electromechanical switching assets that were last used in January 1987. The total Oregon step by step and crossbar depreciation reserve accounts for these assets currently have negative balances totaling approximately $5.938 million. USWC's total Oregon plant in service account also includes $243,000 for this unused equipment. A negative depreciation account balance increases the rate base on which USWC may earn a rate of return.

Staff argues that the step by step and crossbar accounts were scheduled to be completely amortized for intrastate purposes by June 30, 1989. Staff therefore proposes to reduce the total Oregon rate base in this case by $6.181 million, the sum of the negative depreciation account balances and the $243,000 in the Oregon plant in service account.

USWC contends that the negative depreciation reserves are largely due to unexpectedly high costs of removal of the equipment. USWC admits that its negative depreciation reserve balance should be decreased by $2.236 million because USWC charged Oregon for State of Washington reclamation costs. USWC proposes to transfer the remaining negative depreciation reserve balance to the digital switch reserve account.

Background. In 1985, the Federal Communications Commission (FCC) approved a 4.5 year amortization of the step by step and crossbar accounts to address imbalances in the depreciation account reserves. FCC Order No. 85-656, 103 FCC 2d 185, 190-191 and 220. The Order, at 190, notes that the Commission and Pacific Northwest Bell (now USWC) agreed that the amortization procedure should be used so the utility would have a chance to recover its embedded costs. The intrastate amortization was scheduled to end by June 30, 1989.

On January 13, 1989, Mr. Conrad, USWC's Director of Capital Recovery, wrote a letter to Commission Staff that stated in part:

> Based upon an analysis of year end balances, it appears that the Step account will be fully amortized, except for minor trueups, at the end of the scheduled amortization. For the Crossbar account however, the additional six months of amortization will likely create an overaccrual situation of approximately $1M. As you suggested, we will allow the amortization to run its course, as prescribed, and true up any overaccrual in year end 1989 business. This will allow us to take into account any other entries, such as gross salvage and cost of removal, that will be made during the year.

USWC argues that no explicit order or directive mandated an earlier elimination of the negative reserve balances. USWC characterizes the FCC's order as a guideline only, and contends that Mr. Conrad's letter is open to interpretation. We find Mr. Conrad's letter clear enough. It projects full amortization of the step by step account except for minor trueups and an overaccrual in the crossbar account, which will be amortized and trued up at year end 1989. The letter indicates that USWC was well on its way to reducing or eliminating the negative balances in these accounts. Instead, ten years after the equipment was retired, these accounts still have a negative balance of about $6.181 million.

Discussion. At issue here is not whether USWC was required to bring these account balances to zero at the end of the scheduled amortization period. At issue is whether the approximately $6.181 million, less the misallocated $2.236 million, should be included in rate base. USWC is permitted to earn a return on rate base, which is, with narrow exceptions, utility property that provides the service for which rates are charged. *See Pacific Northwest Bell Tel. Co. v. Sabin*, 21 Or App 200, 205 n. 4, *rev den* (1975). These reserve balances relate to plant that has long been out of service.

USWC had many options for dealing with the negative reserve balances in these accounts. Under the accounting procedures in place when the equipment was retired, dead or dying depreciation account reserve imbalances that were not material (that is, not greater than 1% of current depreciation expense) were to be charged to operating expenses for the then current period. Material amounts could be amortized if the company proposed an amortization schedule. Therefore, any immaterial negative reserve balances in the accounts as of the end of 1989, or later additions to those accounts, could have been eliminated year by year, by charges to ongoing expenses under accepted accounting procedures. If the negative reserve balances were material, USWC could have proposed an amortization schedule during its 1991, 1993, or 1995 depreciation dockets.[6]

USWC has determined that the negative depreciation reserves result from four sources:

1. power equipment reclassification;
2. directly charged cost of removal expenses;
3. retirement activity; and
4. allocated cost of removal expenses.

We address each of these categories and determine how the amounts in question should be handled.

1. *Power equipment reclassification.* During the last six months of 1989, USWC transferred power and other support equipment from the retired step by step and crossbar accounts to the digital switch account. This transfer occurred after the step by step and crossbar account reserves were to have been fully amortized under the agreement reflected in FCC Order No. 85-656. The step by

[6] The docket and order numbers relating to those cases are, in order: UM 400, Order No. 91-1276; UM 694, Order No. 94-2064; and UM 767, Order No. 96-177. Pursuant to OAR 860-014-0050, we take official notice of these orders.

step reclassification was $.3 million and the crossbar reclassification was $1.1 million.[7]

The transfer itself is not at issue here. However, the transfer increased the negative balance in the step by step and crossbar accounts. The increased negative balance could have been dealt with in the trueup Mr. Conrad foresaw for the end of 1989 or in the 1991, 1993, or 1995 depreciation dockets. The increased negative reserve could also have been handled as part of the previously approved amortization of the imbalances in the accounts. The 1987 FCC amortization of the remainder of the reserve accounts took just two years; the Oregon amortization of the accounts was 4.5 years. If USWC had acted promptly under procedures that were available to it, the effects of the plant equipment reclassification on the negative reserves could have been eliminated long ago.

2. Directly charged costs of removal. The second source of the increase in the negative reserves is labor and material removal costs that were directly charged to the step by step and crossbar accounts from 1989 through 1992. These charges, which amount to $2.7 million and $1.2 million respectively, were incurred in connection with a cleanup project to bring certain central offices up to code and remove cut dead equipment. The 1989 charges should have been dealt with in the 1989 trueup. The subsequent years' costs should have been expensed, not added to rate base.

3. Retirement activity. This category involves plant retirements for the step by step and crossbar plant, which occurred through 1989 with a clean up of records through 1991 and subsequent years. The retirements should have been dealt with in a 1989 trueup or amortization. Subsequent retirements due to record clean up should have been charged to depreciation expense each year,

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[7] A capital asset transfer occurred with respect to these accounts, but USWC's witness on this issue, Ms. Mulcahy, was uncertain as to when it took place. The crossbar account began 1989 with a plant balance of about $211,000. The January 1, 1989, crossbar asset account balance was therefore not large enough to allow a plant transfer commensurate with the reserve account transfer of $1.1 million that occurred during the last six months of 1989.

not added to rate base. The retirement amounts should not be in rate base for purposes of this case.

4. Allocated costs of removal expenses. USWC admits that it made two accounting errors with respect to this category of charge. First, from 1991 through 1995, it charged amounts to these accounts that should have been allocated to other accounts. Second, from 1989 through 1995, it allocated Washington reclamation costs to Oregon. Those errors account for $2.236 million, and USWC agrees that rate base should be reduced by that amount. However, USWC argues that the remaining $1.2 million in reclamation costs should be assigned to the digital switch account.

We conclude that USWC has not established that such a transfer is appropriate. First, USWC should have written off as depreciation expense the actual step by step and crossbar reclamation costs. USWC could also have expensed or amortized those costs.

Second, USWC admits that the 1991-1995 reclamation charges were not tracked to specific equipment. Because all the Oregon step by step and crossbar equipment was removed by 1989, we cannot determine that any portion of these later reclamation charges are related to equipment used in Oregon. USWC has not shown these to be reasonable Oregon costs.

Third, USWC’s warehouse record keeping creates an allocation problem. The Portland warehouse where the reclamation occurred serves Oregon and Washington, but did not allocate reclamation costs by state. It is possible that other Oregon accounts, such as the digital switch account, have improperly been charged with Washington expenses. The warehouse also processed central office equipment other than step by step and crossbar equipment. Thus the reclamation costs in the years after 1989 likely involved these other types of equipment. The inadequacy of USWC’s record keeping presents a reasonable likelihood that the claimed expenses are misstated due to geographical allocation errors. Therefore, we decline to assign the portion of the negative depreciation account reserve to a successor account for purposes of this rate case.

Disposition. In the past we have allowed utilities to include unrecovered investment in prematurely retired plant in the cost of replacement equipment. *See, e.g.,* UM 528, Order No. 93-1678. The underlying basis for such allowance is that customers are better off because the dollars saved by prematurely retiring plant are greater than the cost of building new plant. *See* UE 88, Order No. 95-322 at 33. Here, however, the company seeks to recover not capital assets but removal costs, particularly those that accrued after an amortization.

We have also recognized that a company may seek adjustments in depreciation rates when an unanticipated premature retirement becomes likely, to avert reserve deficiencies. *See* UM 204, Order No. 90-837. Here, however, USWC does not assert that the step by step and crossbar equipment was prematurely retired. Instead, USWC claims that the negative reserves are due largely to high removal costs. The removal and reclamation costs thus have nothing to do with the replacement technology or the accelerated application of new technology. Moreover, a depreciation reserve transfer should follow capital assets that have been transferred to a successor account, which is not the case here.

We conclude that it is inappropriate to include the negative depreciation account reserve balances in rate base. This conclusion is consistent with our prior decisions, as noted above. None of our decisions permit a depreciation reserve account deficiency transfer more than seven years after the conclusion of an original amortization and nine years after the assets were last used and useful. We therefore disallow the $6.181 million amount of the negative depreciation reserves. In permitting the 1985 through 1989 amortization of the step by step and crossbar reserve imbalances, we gave USWC the opportunity to address potential reserve deficiencies in advance, as contemplated by UM 204 and Order No. 90-837. USWC had ample opportunity to true up, expense, or amortize these accounts before now. USWC has not justified transfer of the 1991-95 misallocated reclamation costs to other accounts. We find that USWC has failed to establish that it is reasonable for it to earn a return on these items.

Issue 2. Cost of Capital. The entire section, pages 20-37 of Order No. 97-171, is readopted:

Completely Settled Issues:

- *Issues 2 a-b, Cost of Debt and Capital Structure*. Staff and USWC agree to a cost of debt of 6.98 percent with a capital structure of 44.5 percent debt and 55.5 percent equity. *See* Appendix B, First Stipulation, Paragraphs 2a-b.

Significantly Undisputed Issue:

- *Issue 2d, Interest Coordination (Adjustment 15).* Staff and USWC agree that interest coordination should be computed using the weighted cost of debt (3.1061 percent) times net rate base. *See* Appendix B, First Stipulation, Paragraph 2c.

Disputed Issue:

Issue 2c, Cost of Equity. USWC proposed a return on equity of 12.5% in its original filing. The company subsequently revised its requested return on equity to 13.75%. That amounts to a return on rate base of 10.74%. Staff recommends a range of return on equity of 10.2% to 12.9%, with 11.6% as the midpoint. Staff's recommendation amounts to a range of return on rate base of 8.77 to 10.27%. The amounts of three adjustments depend on the resolution of this issue:

- Issue 4a, Rent Compensation Study (Adjustment 17)
- Issue 4e, Affiliated Interest Return Component (Adjustment 21)
- Issue 4h, Nonregulated Costs Removed in Adjustment 21 (Adjustment 23a)

Issue 2c: Cost of Equity

Ratemaking Standard: The rates the Commission sets in this case must provide the utility's investors an opportunity to earn a return that is commensurate with those earned in enterprises of similar risk and sufficient to enable the company to attract capital. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 689-90 (1923).

Cost of Equity: The cost of equity capital, or required return on equity, is the rate of return expected by investors on alternative investments of equivalent risk. USWC and Staff were unable to agree on the appropriate cost of equity capital.

USWC's original recommendation for the return on equity was 12.5%. In its rebuttal testimony, filed in October 1996, USWC updated its rate of return recommendation to reflect the developments that have occurred in the telecommunications industry and the financial markets since its direct testimony was filed. Those events are the Telecommunications Act of 1996, which opened local telecommunications markets to competition, and the FCC’s Interconnection Order, which implemented the interconnection provisions of the Act. USWC argues that these events have increased its risk and caused it to revise its cost of equity estimates upward. The updated testimony also adds a direct analysis of USWCG’s stock. The updated return on equity recommendation is 13.75%.

Staff’s recommendation is a return on equity of 11.6%, or 10.2% if the Commission accepts Staff’s proposal of a service quality adjustment.

Both USWC and Staff use the Discounted Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) methods to determine the cost of equity capital. Staff and the company differ significantly on a number of variables in each method, however.

Discounted Cash Flow Method

The DCF method is one standard way of determining the cost of equity. This method assumes that a firm’s current stock price is equal to the present (that is, discounted) value of all expected future dividends from the investment. The constant growth DCF method computes an investor’s expected return on equity using current stock price, the expected dividend in the coming year, and the expected growth rate of future dividends. The basic constant growth DCF formula is:

$$k = D_1 / P_o + g,$$

where “k" is the cost of equity capital, "D_1 " is the expected cash dividend per share for the next period, "P_o" is the current stock price, and "g" is the expected long run growth rate in cash dividends.

Although Staff and USWC agree generally that the DCF method is an appropriate tool to determine a utility’s cost of equity, they disagree on some key issues. They disagree on the sample of comparable firms and about the effect of the Telecommunications Act and the FCC Interconnection Order on stock prices.

Telecommunications sample, comparable companies, and targeted stock. Both the DCF model and the CAPM method involve applying a financial model to data from a company or a group of companies. In his opening testimony, Mr. Cummings, USWC's cost of capital witness, applies the DCF model to two groups of proxies for USWC: a sample of telecommunications companies and a sample of companies with risks thought to be comparable to USWC's. Mr. Cummings states that he uses data from two sets of companies because broader market evidence limits the potential for error or bias inherent in using data from just one company. In November 1995, U S WEST, Inc., issued targeted stock for its two main business groups, Communications Group (USWCG) and Media Group. In his rebuttal testimony, Mr. Cummings applied the model to USWCG targeted stock as well.

Staff applied the DCF model to a sample of 10 telecommunications companies. Mr. Thornton, Staff's cost of capital witness, used this sample rather than analyzing USWC itself because the new USWCG financial reports and stock prices are not comparable to the U S WEST, Inc., financial reports and stock prices that existed before targeted stock was issued. Mr. Thornton contends that applying the CAPM and DCF models to samples of firms in the same industry mitigates measurement errors that may arise in estimating a single company's return on equity in isolation. Mr. Thornton's sample companies include only companies:

- covered by Value Line in the "Telecommunications Services Industry" reviews,
- that are primarily local exchange carriers,
- that have not omitted an annual dividend in the past five years,
- which Value Line forecasts continued dividend payments,
- for which it was possible to calculate CAPM betas, which measure relative riskiness, for consistency with Mr. Thornton's CAPM analysis.

Staff takes issue both with USWC's selection of comparable companies and with USWC’s treatment of its telephone company sample. The comparable companies include, for instance, Anheuser Busch, a brewer, can manufacturer, and theme park operator. Staff argues that USWC's comparable companies are on average riskier than USWC.

As to the telephone company sample, Mr. Cummings’ final DCF estimate for his group of telephone companies is 13.7%. Mr. Cummings originally included nine telephone companies in his DCF estimates and determined a range of DCF estimates for those companies of 7.5 to 15.3%, with an average of 12.9%. Mr. Cummings then eliminated the minimum and maximum values of the population sample to arrive at the truncated mean for the sample, 13.3%. Mr. Cummings then eliminated four companies from his sample because they announced merger intentions in April 1996, and computed a truncated mean on the reduced sample to yield the 13.7% figure. Because it derives from a truncated mean, the 13.7% figure is an average of only three companies. Staff argues that this procedure illustrates Mr. Cummings’ tendency to bias results upwards.

We share Staff’s concerns about Mr. Cummings’ treatment of his telephone company sample. We are also persuaded that Mr. Thornton’s group of telecommunications firms is more similar to USWC than Mr. Cummings’ group of other firms, that Mr. Thornton’s reasons for not analyzing USWCG itself are sound, and that Mr. Thornton’s larger sample of ten telecommunications companies does more to mitigate measurement errors than Mr. Cummings’ sample of three. We therefore conclude that Staff’s selection of companies for its application of the DCF model is preferable to USWC’s selection of companies.

Effect of Telecommunications Act and Interconnection Order. USWC argues that cost of equity estimates should be updated to reflect events since the company filed its direct testimony in December 1995. Specifically, USWC contends that the Telecommunications Act of 1996 and the FCC Interconnection Order have increased the risk to which USWC is subject. Mr. Cummings testified that Regional Bell Operating Company (RBOC) stocks were up 3.6% from the first of the year prior to the passage of the Telecommunications Act in February 1996. Between the passage of the Act and issuance of the FCC order in August 1996, RBOC stocks fell 12.1%. At the time Mr. Cummings prepared his testimony, toward the end of October 1996, RBOC stocks were down 9.8%, while the Standard & Poors (S&P) 500 stocks and the market index, were up 13.8%.

Staff investigated Mr. Cummings's claims and determined via statistical analysis that 76% of the change in RBOC stock prices after issuance of the FCC order appears to be related to interest rate changes, indicating that the drop in RBOC stock prices was largely related to rising interest rates. Staff further notes that the FCC interconnection order has been stayed indefinitely. Staff also states that the decline in RBOC stock performance follows an overperformance in the last half of 1995. Staff cites a Merrill Lynch analyst's report written after issuance of the FCC order:

> RBOCs are down 10% as the market is up 7% this year. This year to date 17% underperformance of the RBOC group is due mostly to the down trend in the bond market (down 11% ytd) and the group's rally in the second half of 1995 (30%+ outperformance of the S&P 500).

In rebuttal testimony, Mr. Thornton stated that lower RBOC prices may be due to expectations of potentially lower earnings and dividend growth rates, not increased risk. Mr. Cummings replies that analysts' earnings growth rate expectations for RBOC stocks are not significantly changed from September 1995 to November 1996. Mr. Thornton responds that the steady earnings growth expectations for the RBOCs support his position that risk has not increased due to the Act and order.

Staff also points out that Mr. Thornton's telecommunications company sample raw beta, calculated from data through 1994, is .80; Mr. Cummings' unadjusted beta for his telecommunications company sample calculated from data available through August 1, 1996, is .78.

AT&T cost of capital witness Carter also argues that the Act and the FCC order have not increased the risk of USWC stock. Mr. Carter bases his conclusions on the facts that Value Line's beta and safety rank measures of risk have not increased for the sample telecommunications companies. Moreover, Mr. Carter points out that USWC's provision of local service will remain a monopoly at least at the wholesale level in the near future. Finally, Mr. Carter notes that the Commission has previously found that any increase in risk that might occur from competition will be reflected in the data underlying the DCF and CAPM analyses.

We conclude that there is no need to update Staff's analyses. We are persuaded that the 1996 Telecommunications Act and the FCC order have had little effect on the riskiness of telecommunications stocks. With the stay of the FCC order, we are persuaded that the risk represented by competition will be slow in appearing. We also find it plausible that increased interest rates and overperformance account for much of the fluctuation in RBOC stocks from 1995 to 1996. Finally, we agree that any increased risk from competition will be captured in the underlying data used for the DCF and CAPM analyses.

Technical Differences between USWC and Staff in the DCF Model: USWC and Staff have a number of technical differences with respect to the use of the DCF model:

1. Mr. Thornton uses the annual DCF model, whereas Mr. Cummings uses an unadjusted quarterly DCF method to measure dividend cash flows to the investor;

2. To determine the current stock price input, Mr. Thornton uses a spot price,

whereas Mr. Cummings uses a two week average of prices;

3. To estimate next year's dividends, Mr. Thornton uses Value Line's expectations of dividends over the next 12 months, whereas Mr. Cummings uses his own dividend forecast; and

4. To estimate future dividend growth rates, Mr. Thornton uses an internal growth approach for his constant growth model and uses Value Line historical dividend growth for his nonconstant growth model, whereas Mr. Cummings uses short to intermediate term earnings growth forecasts as a proxy for infinite dividend growth.

1. Quarterly v. Annual DCF. USWC modifies the standard DCF model to account for quarterly dividend cash flows to the investor, as they are actually paid out. Staff uses the model that assumes dividends are paid once a year. USWC argues that modeling cash flows quarterly, as investors receive them, is more accurate than Staff's approach.

Staff replies that the annual model is appropriate in this case and cites UT 113, Order No. 94-336 at 14-15, where the Commission dealt with this issue and resolved it in favor of the annual model.[8] Staff also concedes that both models have shortcomings. The annual model does not capture the quarterly payment of dividends. The quarterly model can correctly estimate an investor's effective required rate of return. But Staff relies on an academic article by Linke and Zumwalt[9] to show that the quarterly model should not be applied to a regulatory rate base without a three step downward adjustment, which Mr. Cummings did not perform. The adjustment steps, described in Linke and Zumwalt at 19, account for the reinvestment assumption and for the regulatory rate base to which the allowed return on equity is applied.

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[8] We take official notice of Order No. 94-336 pursuant to OAR 860-014-0050.

[9] "Estimation Biases in Discounted Cash Flow Analyses of Equity Capital Cost in Rate Regulation," *Financial Management*, Autumn 1984.

In defense of its use of the annual model, Staff notes that the annual model can produce the correct return on equity estimate, even without capturing the quarterly payment of dividends, assuming the utility reinvests its retained earnings on a quarterly basis and earns on the increased investment. Therefore, Staff concludes that the annual DCF model is appropriate for beginning of period ratemaking.

The current case is based on average of period ratemaking. The end of period rate base here is higher than the beginning of period rate base. According to Mr. Thornton, the annual DCF model estimate must be adjusted downward if applied to an average of period rate base. Staff did not make this adjustment. Therefore its annual DCF model is biased in USWC’s favor.

USWC’s quarterly DCF model also does not take into account the fact that USWC receives monthly revenues from its customers. That gives USWC the opportunity to reinvest its monthly earnings and to earn more than its authorized return on equity. Staff demonstrates that a nominal rate earned on a monthly basis will produce the effective (quarterly DCF) rate over a year when applied to beginning of month book values (rate bases). Assuming that Mr. Cummings’ 12.1% quarterly DCF estimate for telephone companies is correct, Staff argues that the estimate should be reduced to 11.5 %, the nominal return that would earn the company 12.1% if compounded monthly beginning with the original investment. The existence of monthly revenues to USWC therefore also requires a downward adjustment, which Mr. Cummings did not make.

On review of the record and the arguments advanced by USWC and Staff, we conclude that both the annual and the quarterly DCF models require adjustments to eliminate bias and error. USWC did not adjust its quarterly model to account for the application of the quarterly model to regulatory rate base or for the monthly receipt of revenues. Staff did not adjust its annual DCF model downward to account for average of period rate base. If it had, the higher return produced by considering quarterly dividends would have been more than offset. Both the USWC and Staff DCF approaches give too high a result, but we conclude that Staff’s recommendation is the more reasonable approach in this docket.

2. Current Stock Price Input. There are two subissues with respect to this dispute. First, there is a question whether it is appropriate to average stock prices over a ten day period or choose a spot price from a single day; second, there is an issue of whether the stock price should be updated to account for events that have transpired since testimony was filed.

For the current price variable in the DCF model, USWC used an average of the daily closing stock prices for the ten trading days, November 1 to November 14, 1995. Mr. Cummings chose a ten day average to guard against the possibility that the selected stock price might be anomalous in reaction to a news story or other external event.

Mr. Thornton chose the spot prices closing on July 2, 1996, as reported in the July 3, 1996, *Wall Street Journal*. Staff argues that the most current spot prices are the appropriate prices to use for the P_O term in the DCF model, because under the efficient markets hypothesis as advanced by modern corporate finance theory, those prices include all information incorporated into historical prices, plus the most recent information.

In UT 113, Order No. 94-336, we considered whether a spot price or an average of prices was superior. We stated, at 13:

> Conceptually, the stock price to use is the current price of the security at the time of estimating the cost of equity. In an efficient market, the current stock price provides the best indication of future prices. An efficient market implies that prices adjust instantaneously to the arrival of new information. Therefore current prices reflect the fundamental economic value of the security.

Here, as in that docket, we conclude that Staff's method of calculating stock price based on spot prices is more reasonable than averaging prices because it is more consistent with the theory of efficient markets. We have already addressed the problem of updating stock price information, under the discussion of risk from competition above.

3. Estimation of the Next Year's Dividend. To estimate next year's dividends, the "D_1" term of the DCF model, Mr. Cummings makes his own forecast using historical dividends and expected earnings growth rates.

Mr. Thornton uses Value Line's expectations of dividends over the next 12 months for the "D_1" term. Staff took the ratio of D_1 to P_o, the current stock price, for each company in his sample and averaged the ratios to arrive at an average required dividend yield of 3.5%. Staff asserts that its method is more direct than USWC's and that USWC's method is flawed in using forecasted earnings growth to forecast dividend growth over the coming year.

Staff supports its position with the argument that near term earnings growth forecasts are unduly influenced by earnings cycles, making them unreliable as predictors of earnings growth in the long term. Dividend growth is a function of earnings growth in the long term. Near term dividend growth may not even be related to near term earnings growth, Staff argues, because companies smooth dividend payments in the face of earnings cycles.

We are persuaded by Staff's argument. The horizon for the earnings growth forecast is too short and is subject to the possible distortions of earnings cycles. We find that Staff's approach to estimating next year's dividends is more reasonable, and adopt it.

4. Estimation of Future Dividend Growth Rate. To estimate the expected dividend growth rate, the "g" term of the DCF model, Mr. Cummings uses Institutional Brokers' Estimate System (IBES) analysts' expectations of earnings growth one to five years forward. His result is a 6% growth rate. In support of his method, Mr. Cummings quotes from a research study that USWC provided to Staff in response to a data request:

> We have compared the accuracy of four methods for estimating the growth component of the discounted cash flow yield on a share: past growth rate in earnings (KEGR), past growth rate in dividends (KDGR), past retention growth rate (KBRG), and forecasts of growth by security analysts (KFRG). . . . For our sample of utility shares, KFRG performed well, with KBRG, KDGR, and KEGR following in that order.
>
> The superior performance by KFRG should come as no surprise. All four estimates of growth rely upon past data, but in the case of KFRG, a larger body of past data is used, filtered through a group of security analysts who adjust for abnormalities that are not considered relevant for future growth.[10]

Staff uses two different annual DCF models in its analysis: the constant growth model and the nonconstant growth model. In the constant growth model, Mr. Thornton uses the internal growth approach to estimate future dividend growth. This approach is based on the observation that dividends grow by a firm's book return on equity (b) times the amount of equity retained in the firm, also called the retention ratio (r). The

[10] David A. Gordon, Myron J. Gordon, and Lawrence I. Gould, "Choice among Methods of Estimating Share Yield," *The Journal of Portfolio Management*, Spring 1989, pp. 50-55.

b * r growth model is based on a review of historical data from Value Line, of which investors are aware. The b * r approach is appropriate if the retention ratio for a firm is fairly constant and the market to book (M/B) ratio is expected to be 1.0. Mr. Thornton notes that the retention ratio has been reasonably constant in the telecommunications industry, but the M/B ratio is well above 1.0, based on investors' expectation that the telecommunications services industry will earn substantially more than its cost of capital.

To correct for this expectation, Mr. Thornton added a second growth term to his b * r growth rate range, the term "v * s." The variable "v" represents the fraction of funds raised from common stock sales that accrues to old shareholders. The variable "s" represents an expected rate of increase in common equity from stock sales. Mr. Thornton then adds his v * s estimate to his b * r growth rate range to calculate his constant growth rate range.
Mr. Thornton's v * s estimate is 1.8%; his b * r growth rate range is 2.6% to 8.9%. Accordingly, his range of DCF estimates based on the constant growth approach are 7.9% to 14.2%, which averages to 11.1%.

The nonconstant growth DCF model estimates investors' forecasts of dividend growth and allows expected annual dividends to grow at different rates over time. This approach allows an analyst to incorporate near term dividend growth rates that are much lower or higher than a long run expectation.

Mr. Thornton used two nonconstant analyses to estimate growth. Both are based on a finding that dividend growth in the telecommunications industry has been relatively stable. Therefore, Mr. Thornton forecasts future growth based on historical dividend growth, using up to 19 years of data.

For his first nonconstant growth analysis, Mr. Thornton uses historical dividend growth as a proxy for future dividend growth. His result is 9.3%. For his second analysis, Mr. Thornton uses

Value Line forecasts of dividend growth through the year 2000, and then uses historical dividend growth beyond that. His result using this method is 9.2%. The results average to 9.3%.

Mr. Cummings takes issue with Staff's numbers in its use of b * r growth rates. Mr. Cummings notes that Staff’s work papers show a large difference between the average historical b * r growth rates from 1988 to 1995 and the forecasted b * r growth rates for 1996, 1997, and 1999-2001. The numbers change from 5.71% for 1988-1995 to 14.74% for 1999-2001.

Given such growth, Mr. Cummings notes that Staff provides no explanation why an average of 1988 to 1995 b * r growth rates would reflect investors’ expectations for future growth, and also calls the accuracy of the numbers into question.
Mr. Cummings believes that analysts’ forecasts are a better proxy for future growth in dividend cash flows than an average of historical growth, which Mr. Thornton uses in his nonconstant growth model.

We conclude that Staff’s analysis of the growth rate is more direct than USWC’s. Staff relies on historic and forecasted *dividend* data, and USWC relies on near and short term *earnings* growth forecasts. Over a period of five years or less, the growth in dividends paid by a company may not always equal earnings growth, although it must in the long run. Staff’s general approach is, thus, superior to USWC’s.

To validate its method over Staff’s, USWC relies on a passage Gordon, Gordon, and Gould, set out above. This passage is too vague to serve as an argument in favor of its method in this case. Moreover, the company argues that it uses long term forecasts of earnings in its analysis, but the record indicates that it uses growth forecasts only one to five years forward. We conclude that Staff’s use of dividend data is more reliable than USWC’s use of earnings data.

Staff performed a constant growth analysis and two nonconstant growth analyses to arrive at its estimate for "g." Staff’s procedure was thus more thorough and contained more internal checks than USWC's. USWC objects to the forecasted growth numbers in Mr. Thornton's work papers, but does not specify the basis for its objection. USWC only notes that it questions why an investor's expectations would be based on past growth rates when future growth rates are greater. We believe that Staff cured any potential flaw in its inputs by using a combination of several approaches to determine its "g" estimate. We adopt Staff's ranges for the growth term.

Final DCF Range of Estimates. Staff's final DCF range of estimates is 9.2% to 14.2%, with a midpoint of 11.7%. Mr. Thornton derived this range by eliminating his lowest estimate (7.9%), on the ground that he did not expect the cost of USWC's equity to be as low as that.

USWC's final DCF range of estimates is 12.6% to 13.7%, and a point estimate for USWCG of 13.9%.

DCF conclusion: Incorporating the dividend yields and growth term ranges derived by Staff and adopted above, the Commission concludes that an appropriate range for DCF is 9.2% to 14.2%, with a midpoint at 11.7%.

Capital Asset Pricing Model

The CAPM is a risk premium analysis that calculates the expected equity return by estimating a risk free rate of return and adding a risk premium. Staff and USWC agree that the basic CAPM formula is:

Expected return for a stock = risk free return + (relative risk [beta] for the stock * market risk premium).

The CAPM is a holding period model that requires estimates of the risk free interest rate, the relative risk, or beta, for a stock, and the market risk premium over the assumed holding period. The analyst must select the holding period. The holding period assumption dictates consistent estimation choices for the risk free interest rate and market risk premium. The CAPM model expresses the average beta as 1.0.

USWC and Staff disagree on each aspect of CAPM in this case:

1. The assumed holding period;
2. The risk free rate of return;
3. The estimate of beta, including the propriety of weighting betas; and
4. The market risk premium.

1. The Assumed Holding Period. The holding period is assumed prior to the determination of the risk free interest rate and the market risk premium in the CAPM model. The risk free rate is estimated with reference to the yields of U.S. Treasury securities. The yields for U.S. Treasury securities vary directly with the term of the securities. Short term and intermediate term securities normally have a lower yield than long term securities.

Mr. Thornton assumes an intermediate term holding period for his CAPM analyses, in conjunction with his use of intermediate term U.S. Treasury securities for his risk free rate of return. Mr. Thornton makes this choice of holding period because he believes that the intermediate term corresponds more closely to the typical period for which rates are in effect. In this case, rates will likely be in effect from May 1996 through December 1998. Moreover, Mr. Thornton believes that intermediate term U.S. Treasury securities avoid both the volatility of short term U.S. Treasury bills and the risk premia of long term U.S. Treasury bonds.

Mr. Cummings also uses intermediate term Treasury securities as a risk free rate. However, USWC also uses a long term risk free rate in its CAPM estimates. Mr. Cummings chooses U.S. Treasury security rates with three to thirty years' maturity for his risk free rate; Staff argues that that indicates an assumed holding period of three to thirty years. According to Staff, Mr. Cummings' attempt to estimate both intermediate term and long term market risk premia suggests assumed intermediate and long term holding periods.

Mr. Cummings testified that for telecommunications industry stocks, the expected holding period is less than three years. He distinguishes between portfolio turnover and investment horizon, noting that investors turn over their portfolios every one to three years, not every thirty years. He states that equity investors rebalance their portfolios often but have a long term focus for their portfolio investment. Therefore, he concludes that equity investors' holding periods do not have to be thirty years long to use a thirty year U.S. Treasury bond as a risk free rate.

In his direct testimony, however, Mr. Cummings equates investment horizon and holding period: "In practice, however, common stock investments are actively traded in the capital markets, indicating that investors have relatively short investment horizons or expected holding periods."

We conclude that Mr. Cummings has inconsistently assumed conflicting holding periods. This inconsistency biases his cost of equity estimates upward. Staff's holding period assumption is more reasonable, because it is internally consistent and because it tracks better than USWC's with the time the rates from this case will be in effect.

2. Risk Free Rate of Return. As noted above, the CAPM requires an estimate of the risk free rate of return. Staff's analysis assumes an intermediate holding period and relies on the average of spot yields for intermediate term U.S. Treasury securities.[11] Staff's risk free rate estimate is 6.6 %.

Mr. Cummings' risk free rate is 7.09%. He uses thirty year U.S. Treasury securities for his risk free estimate. Staff argues that Mr. Cummings' use of long term securities is inappropriate because it is inconsistent with his holding

[11] Staff's intermediate term securities are five, seven, and ten year securities. Mr. Thornton took the rates from the July 3, 1996, edition of the *Wall Street Journal*, as noted in the DCF discussion above. The rates averaged 6.66%. Because this case is based on an average of period rate base, which requires a downward adjustment (see discussion of DCF model above), Mr. Thornton adjusted the rate downward to 6.57%, then rounded to 6.6%.

period assumption, as noted above, because it causes an upward bias in his market risk premium estimation for holding periods greater than one year (see discussion at 3. below), and because long term bonds include a liquidity risk premium that must be extracted before they are used in a CAPM analysis. Mr. Cummings disagrees that a risk premium must be extracted from long term bonds.

As discussed above, the holding period assumption should be much shorter than thirty years in this case, where rates will likely be reexamined in late December 1998 and the cost of capital will be reestimated based on market conditions at that time. An investor with a short holding period is exposed to large potential gains or losses by purchasing a long term instrument, because the instrument will be sold before it matures. For CAPM analysis, therefore, a U.S. Treasury security with a maturity greater than the assumed holding period should not be used as a proxy for the risk free rate.

We agree with Staff that the long term Treasury rate includes a liquidity risk premium.[12] As Mr. Thornton pointed out, it is possible to correct the long term Treasury yield by subtracting the liquidity risk premium. Mr. Cummings did not make this correction. We conclude that Staff's risk free rate is the more appropriate.

3. Beta. Beta is a measure of that portion of a company’s risk that cannot be diversified away. The market risk premium is multiplied by the company’s beta to determine investors’ required return above the risk free rate.

Mr. Thornton used the Fisher-Kamin regression technique to calculate his beta estimate.[13] He estimated the beta of his sample telecommunications companies to be .80, based on data through 1994. (When he included 1995 data,

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[12] Staff/4, Thornton/43, citing Brealey and Myers, *Principles of Corporate Finance*, 3d ed., McGraw-Hill Book Co., New York, 1988, p. 184.

[13] The Commission has previously approved this beta calculation method. *See, e.g.,* Order No. 94-336 at 25; Order No. 87-406 at 66; and Order No. 80-634 at Appendix, 21-22.

the beta dropped to .72.) To arrive at his beta estimate, Mr. Thornton regressed his sample companies’ stock returns minus the risk free rate on the New York Stock Exchange returns, also minus the risk free rate. The pertinent data for beta estimation includes market portfolio returns, company stock returns, and risk free rates. Mr. Thornton used the Center for Research in Securities Prices (CRSP) value weighted index of New York Stock Exchange stock returns as a proxy for the portfolio returns and for data on his sample’s stock returns. Mr. Thornton drew his risk free data from Ibbotson Associates’ publication, *Stocks, Bonds, Bills, and Inflation 1995 Yearbook*. Both CRSP and Ibbotson data series ran from 1926 through 1994.

To estimate USWC's beta, Mr. Cummings uses daily data, based on 219 trading days. Value Line uses five years of weekly data to estimate beta. The shorter data frequency on which Mr. Cummings relies biases his beta estimate upward.
Mr. Cummings argues that he corrects for the daily beta bias statistical problem by using the Dimson and modified Scholes-Williams regression methods. Mr. Cummings chooses the S&P 500 as a proxy for the market portfolio, and derives beta estimates of .75 and .76 from that group of companies, with an average of .76.

In keeping with the practice of Merrill Lynch, which weight raw betas 1/3 toward 1.0, Mr. Cummings adjusts his .76 average USWC beta toward 1.0, yielding a .84 beta. Then, in a manner similar to Value Line, which weights its betas toward 1.06, Mr. Cummings further rounds upward to .85.

Staff and USWC have a number of technical differences involving the derivation of their respective betas, but their raw betas are almost identical. The betas of Staff and USWC differ because they employ different methods to adjust their raw betas. Mr. Thornton takes an average of telecommunications industry stocks and does not adjust his average beta, arguing that use of the industry average renders adjustment unnecessary. USWC adjusts its beta toward 1.0, the average of all betas (or toward 1.06, using the Value Line adjustment).

We conclude that Staff's telecommunications industry average beta is more reasonable than a beta adjusted toward the average of all betas or toward an even higher standard, such as Value Line uses. As Nobel laureate economist William F. Sharpe says:

> Information of the type shown in Table 13-4 [industry average betas] can be used to "adjust" historic beta values. For example, the knowledge that a corporation is in the air transport industry suggests that a reasonable estimate of the beta value of its stock is greater than 1.0. It thus makes more sense to adjust a historic beta value toward a value above 1.0 than to the average for all stocks.[14]

Mr. Sharpe's support of the adjustment toward industry average is borne out by empirical studies that Staff has performed. Over a number of years. Mr. Thornton testified that Staff has concluded that weighting public utility betas toward 1.0 is inferior compared to weighting betas toward the average industry beta.

Conversely, it makes more sense to adjust a historic company's beta toward a value below 1.0 if it is in the telecommunications services industry, because the record reveals that telecommunications services companies are less risky than the average stock. Thus, if any adjustment to the raw beta is appropriate, it should be toward the industry average rather than toward a generic average of all stocks. Staff points out that if Mr. Cummings' truncated telecommunications company sample average relied on raw betas, rather than betas adjusted toward 1.0 or 1.06, the average beta would be .78, lower than Mr. Thornton's estimate of .80. Because Mr. Thornton's sample takes the average of telecommunications services companies, we

[14] *Investments*, 2d ed., Prentice-Hall, Inc., Englewood Cliffs, 1981, p. 344.

conclude that no adjustment to his raw beta is necessary.

4. Market Risk Premium. The CAPM multiplies the estimated beta by the market risk premium, which must also be estimated. To estimate the market risk premium, Mr. Thornton uses an unbiased estimation method, whereas Mr. Cummings uses a method which he admits is biased upward for holding periods greater than one year.

Mr. Thornton's method assumes that the average market risk premium over a large number of historical intermediate term holding periods is a reasonable estimate of the expected intermediate term market risk premium. He estimates the average historical intermediate term market risk premium by calculating the difference between expected compounded returns on the market portfolio and the compounded returns on the risk free asset over an intermediate period (the holding period assumption discussed in paragraph 1 above). In other words, the market risk premium is the difference in returns between an investor's two accounts, the one invested in the stock market and the other invested in U.S. Treasury securities, over an intermediate period. The difference is then annualized.

Mr. Thornton used CRSP's 1926-1995 New York Stock Exchange/AMEX/ NASDAQ return series as a proxy for the theoretical market portfolio returns (a sample of approximately 8,000 stocks in his last month of data). He used 1926-1995 data in intermediate term U.S. Treasury securities rates from Ibbotson Associates' *Stocks, Bonds, Bills, and Inflation 1996 Yearbook* to represent the risk free rates over that period. Mr. Thornton used two different series from the *Yearbook:* yield (ex ante rates) and total returns (ex post rates). He performed separate analyses on each of the series and generated two series of estimates. He then separated his 1926 to 1995 data into holding periods of five to ten years each, such that all his data were used only once. He then calculated the average rate of return difference between holding the market portfolio and holding the risk free rate over the intermediate term. Finally, Mr. Thornton averaged the market risk premium estimates for each of the holding periods. His estimate of the historical market risk premium using ex post U.S. Treasury security returns is 5.8%; of historical market risk premium using ex ante returns, 6.3%.

Mr. Cummings uses an arithmetic average approach to market risk premia. His estimates are the arithmetic difference between annual stock returns and annual bond returns. All of Mr. Cummings' ex post market risk premium estimates are based on arithmetic averages of annual data. The market risk premium range in USWC's rebuttal testimony is 7.5% to 7.7% for intermediate term risk free rates and 7.1% to 7.3% for long term risk free rates. The ex post and ex ante estimates are very close. USWC argues that this indicates that the estimation of the market risk premium is sound.

USWC objects to the fact that Staff uses only historical data to estimate the market risk premium, whereas USWC uses an average of an historically derived (ex post) and current expected (ex ante) market risk premium. USWC argues that Mr. Thornton’s range is biased downward because his calculation is based on differences of geometric means and the use of bond total returns rather than bond income returns. USWC contends that the theoretical literature and the provider of the data (Ibbotson Associates), as well as investors in U.S. Treasury bonds and the S&P 500 stocks, support the validity of the arithmetic mean procedure.

Staff argues that Mr. Cummings’ estimates are biased upward because, as he admitted on cross examination, a method like his that relies on the arithmetic average of annual data will produce an upwardly biased estimate if the holding period is assumed to be more than one year. Staff reminds us that Mr. Cummings implicitly assumes an intermediate term and long term holding period by his choice of risk free rates. Staff also points out that Mr. Cummings admitted that Staff's method is an unbiased estimator method.

Moreover, Staff takes issue with Mr. Cummings’ ex ante market risk premium. Ex ante has a different meaning in Mr. Cummings’ calculation than the yield that Mr. Thornton used as a term of his analysis. Mr. Cummings uses the term to mean a current market risk premium. Staff points out that Mr. Cummings stated in his direct testimony that the best estimate of the market risk premium, which varies over time around an average or mean, is the average risk premium over the longest period for which data are available. Nonetheless, Mr. Cummings gives equal weight to his ex ante analysis, which involves performing a

DCF analysis on the S&P 500 and subtracting intermediate term or long term interest rates. Staff argues that Mr. Cummings' application of the DCF to the S&P 500 is inappropriate, because he relies in the IBES short term and near term earnings forecasts as proxies for indefinite future growth. This choice skews his results upward, Staff contends.

We are persuaded that Mr. Thornton's method of estimating the market risk premium is superior to Mr. Cummings'. Mr. Thornton uses an unbiased estimator, as Mr. Cummings admits. Appendix IV to Mr. Cummings' direct testimony (USWC Exhibit 14) cites an article by Fuller and Hickman as the source of an unbiased estimation procedure.[15] Mr. Thornton testified that the procedure in that article is substantially the same as the procedure he used in this case to estimate the market risk premium.

USWC argues that the theoretical literature supports Mr. Cummings' position on the arithmetic mean, but the articles included in his Appendix IV indicate that if an analyst has annual data and assumes a holding period of greater than one year, the analyst should compound returns over the assumed holding period before taking an average. This is what Mr. Thornton did with his monthly data. Mr. Cummings' analysis biases his results upward. We conclude that Mr. Cummings' results are less accurate as an estimate of the market risk premium, and adopt Mr. Thornton's estimates.

CAPM conclusion: We have adopted Staff's recommendations on each of the contested issues in the CAPM analysis. Therefore, we adopt Staff's CAPM cost of equity estimates. They are 11.2% for the ex post U.S. Treasury security returns and 11.6% for the ex ante (yield) returns. These estimates average to 11.4%.

Flotation Cost Adjustment

Mr. Cummings proposes to adjust his CAPM and DCF return on equity ranges upward by a factor of

[15] "A Note on Estimating the Historical Risk Premium," *Financial Practice and Education*, Fall/Winter 1991, pp. 45-48.

1.0115 to provide USWC with a return on estimated historical stock issuance costs. Staff recognizes that flotation costs are a necessary cost of business, but recommends that issuance expenses be recovered as an expense item, not through an increase in return on equity. Staff contends that Mr. Cummings' proposed approach improperly gives stockholders a one time gain. Staff also presented evidence that USWC does not expect to require large amounts of new equity financing.

Disposition. We consider stock issuance costs to be expenses. Therefore, such costs must be included in rates when the expenses are incurred. *See* Order No. 94-336 at 28. Recovery of past issuance expenses in future rates would be retroactive ratemaking. *See id.*; *see generally* Letter of Advice dated March 18, 1987, to Charles Davis, Public Utility Commissioner (OP-6076).

Mr. Cummings' proposal amounts to a perpetual return on historical estimated issuance expenses. Under regulatory schemes, bond costs are embedded and have fixed lives. Common stock, however, does not have a fixed life. Bonds are thus not analogous to stock in this context. Approval of the amortization of embedded costs such as fixed life bond expenses over the life of a bond does not justify a perpetual return on estimated historical stock issuance expenses.

We note also that Mr. Cummings' flotation cost adjustment method has no basis in the financial or economic literature. The record discloses that when asked about support for his adjustment method, Mr. Cummings provided an article by Brigham and Gapenski discussing the cost of capital adjustment method (which is also what Mr. Cummings called his method). However, Mr. Cummings did not use the method prescribed in the Brigham-Gapenski article. The article discusses no adjustment to the CAPM for flotation costs. Mr. Cummings admitted that he had seen no professional literature containing mathematical proofs justifying the application of a flotation cost adjustment to the CAPM.

Moreover, a flotation cost adjustment is internally inconsistent with the CAPM. The CAPM assumes that transaction costs are irrelevant, but flotation costs are transaction costs. For the above reasons, we reject Mr. Cummings' proposed flotation cost adjustment.

Coverage Ratio

At Issues 12 and 13, below, we discuss the implications of our decision on USWC's cash flow and business valuation. However, we must also discuss here one aspect of USWC's argument about its viability in view of our decision.
Mr. Cummings argues that Staff's case will cause a negative pretax interest ratio for USWC.
Mr. Cummings supports his contention by hypothesizing a stand alone entity, USWC-Oregon.
Mr. Cummings prepared an exhibit, USWC Exhibit 120, to demonstrate the effect of Staff's case on USWC's pretax interest coverage ratio.
Mr. Cummings states that bond rating agencies calculate interest coverage as follows:

$$\text{Pretax Interest Coverage} = \frac{\text{Pretax Income + Interest}}{\text{Interest}}$$

Staff contends that this exhibit compares an unadjusted USWC test year with Staff's adjusted test year. Staff moreover points out that USWC's calculations do not account for USWC's proposed $34.9 million U S WEST Direct revenue imputation, any revenue requirement adjustments due to the sale of exchanges to PTI, any revenue requirement adjustments due to extraordinary 1995 customer service and maintenance expenses, any adjustments for tariff changes, or any adjustments for reengineering savings. Thus, Staff argues, USWC's Exhibit 120 does not even reflect USWC's adjusted version of the rate case.

Staff has compared Mr. Cummings' pretax interest coverage formula for the hypothetical USWC-Oregon under Staff's adjusted test year after the second stipulation, both before and after revenue requirement reductions. Staff argues that it is clear that USWC-Oregon, if it were a stand alone entity, would have a financially sound interest coverage ratio. Staff notes that Mr. Cummings does not calculate pretax interest coverage in a manner consistent with the formula he provides, which is set out above. Instead, he merely divides pretax net operating income by interest expense.

Staff included an Appendix A to its Cost of Capital brief in which showed the interest coverage ratio calculations for Staff's fully adjusted test year (including a 10.2% return on equity), before and after a rate reduction. Staff uses both the method Mr. Cummings attributes to bond rating agencies and the method he actually uses in USWC Exhibit 120. Appendix A to Staff's Cost of Capital brief demonstrates the following about pretax interest coverage ratios under Staff's case after the second stipulation:

Pretax Interest Coverage Before Rate Reduction

Rating agency method: 9.02
USWC Exhibit 120 method: 8.02

Pretax Interest Coverage After Rate Reduction

Rating agency method: 4.88
USWC Exhibit 120 method: 3.88

Staff points out that a pretax interest ratio coverage of 4.88 places USWC-Oregon above the Standard and Poor's AA benchmark of 4.5 for telecommunications companies, and a ratio of 3.88 places the entity within the A benchmark. Both AA and A ratings are superior to mere investment grade ratings. Staff concludes that a 10.2% return on equity, together with the rest of Staff's adjustments, will allow the hypothetical USWC-Oregon to maintain its financial integrity.

Disposition. Staff's arguments persuade us that Mr. Cummings' pretax interest coverage ratio exhibit, USWC Exhibit 120, does not reflect even USWC's adjusted case. Moreover, as Staff points out, Mr. Cummings does not use the bond rating agency formula to calculate interest coverage. We find that Staff's calculations in Appendix A to its Cost of Capital brief are methodologically correct and demonstrate that USWC-Oregon, if it existed, would have a pretax interest coverage even after rate reduction sufficient to maintain its financial integrity.

Conclusion. Under *Duquesne,* the rates we set in this case must give USWC's investors an opportunity to earn a return commensurate with those earned in enterprises of similar risk and sufficient to enable the company to attract capital. Based on the considerations set out above, we find that Staff's cost of equity analysis is superior to USWC's in meeting these criteria. Mr. Thornton's telecommunications company sample better reflects the risk USWC faces. Mr. Cummings' selection of comparable companies are, on average, riskier than USWC. We find Mr. Cummings' analysis biased upward. Therefore, his analysis fails to meet the *Duquesne* criterion of setting a return like those earned by enterprises of similar risk.

Further, we are satisfied that Staff's recommended return will maintain USWC's financial integrity. Finally, we are persuaded that the return is high enough to attract capital. Therefore, we adopt Staff's recommendation of

10.2% to 12.9% as the reasonable range of return on equity. The midpoint of that range is 11.6%.

Proposal to Set Allowed Return at Low End of Reasonable Range: After establishing a range of a return on equity the midpoint of which is 11.6%, Staff recommends a service quality adjustment to lower the return on equity to 10.2%. We adopt this recommendation. See discussion at Issue 9 below.

Issue 3a, U S WEST Direct Yellow Pages Imputation. The discussion on pages 37-43 of Order No. 97-171 is readopted *except* that USWC may continue to use the retention rate from UT 102, in effect since June 1992; and foreign directory revenues are removed from the imputation. The adjustment to the retention rate increases the annual intrastate revenue requirement by $4.9 million.

ISSUE 3: U S WEST DIRECT DIRECTORY REVENUE IMPUTATION

Disputed Issues:

Issue 3a, U S WEST Direct Directory Imputation (Adjustment 16). Staff and USWC agree that the test year should be adjusted but disagree about the amount of the adjustment and the method used to calculate the imputation. Staff used the method and publishing fee rate adopted in docket UT 85 to calculate revenues from U S WEST Direct. USWC used the $34.7 million directory revenue imputation that was in the UT 85 revenue requirement.

Issue 3b, U S WEST Direct Directory Growth (Adjustment 16a). Staff included growth at the level expected to occur during the period when rates from this docket are in effect. Staff and USWC disagree about the need for pro forma adjustments (*see* Issue 1a, Test Year). If the Commission includes Staff's adjustment in the test year, the final amount depends on the resolution of Issues 3a, Directory Imputation, and 8j, Access Line Growth.

Issue 3a: U S WEST Direct Directory Revenue Imputation

Before the divestiture of AT&T, the local Bell telephone companies published and distributed alphabetical and classified telephone directories (the white and yellow pages) within their service territories. Historically, the publication of telephone directories has been part of the local telephone company's service obligations, and the revenues from directory publishing and advertising have been used to defray the utility's revenue requirement and maintain affordable local telephone rates.

After the breakup of AT&T, directory operations remained with the local telephone companies. Since that time, some of the Bell operating companies, including USWC, have transferred their directory operations to nonregulated affiliates. USWC's current directory publishing affiliate is U S WEST Direct (USWD), which was created in 1986. *See* Order No. 88-488, UI 54, in which the Commission authorized USWC (which was then known as Pacific Northwest Bell, PNB) to enter into various publishing agreements with USWD. But for imputation, the transfer of assets from the regulated utility to a nonregulated affiliate would have diverted the publishing revenues from ratepayers to shareholders.

USWD's directory operation is highly lucrative. The USWD directory dominated the field in 1988, when the Commission approved the publishing agreements, and USWD dominates the field today. Its revenue growth rate has consistently been high; see discussion at Issue 3b below.

Like a number of other states, Oregon opposed this attempt to transfer the assets of the regulated telephone company to nonregulated affiliates without customer compensation. We reasoned that the value of the directories is connected directly to the regulated operations of the local telephone company. The relationship between telephone service and yellow pages advertising in the directories is symbiotic. As we said in Order No. 88-488, at 7:

> [T]he Commission believes that the thing of value which is being transferred, and which makes these Yellow Pages different and much more valuable than others, is their connection with the local exchange telephone company . . . . The distribution of the classified advertising with the necessary white pages by, with the blessing of, or in association with the local exchange company sets [the Yellow Pages] apart from any other classified advertising efforts.

We further reasoned that the local exchange company's position as incumbent telecommunications service provider was conferred on it by the State of Oregon through the Commission. ORS 759.020, 759.025. We concluded that the directory publishing rights, opportunities, and profits are valuable assets that have been derived by the local exchange company in connection with its state authorized position as a monopoly or regulated local telecommunications service provider. In considering PNB's publishing agreements with USWD, we stated (Order No. 88-488 at 8):

> The Commission is not disposed to permit the parent company to spin off the money-making ventures of its operating companies, one by one, thus increasing the net revenues required to support local service. This is especially true when those revenues result from a venture which receives its value from its close association with the communications services provided by the local exchange company.

Accordingly, when we approved the publishing agreements between PNB and USWD, we provided that "the revenues which will be credited to PNB as a result of the transfer will be based on the difference between the revenues received from the publication venture, and the reasonable costs of publication." Order No. 88-488 at 9. In that same docket (UI 54), PNB represented that regardless of the transfer of the directory publishing operation to USWD, regulated ratepayers would continue to benefit from such publishing.

In other words, we have imputed to PNB, now USWC, directory revenues. This imputation lowers USWC's revenue requirement. In PNB's last general rate case in Oregon, UT 85, we determined that

> a level of directory publication expense equal to [***][16] percent of USWD's [Oregon] net revenues is fair and reasonable for

[16] The bracketed data are confidential.

> purposes of this proceeding. The remaining [****] percent of USWD's [Oregon] net revenues should be imputed to PNB, lowering its revenue requirement by $29.066 million. Order No. 89-1807 at 34.

Imputation of directory revenues to USWC is the form of annual compensation that was adopted by the Commission to remunerate the utility's ratepayers for USWD's use of their directory related assets. *See* Order No. 89-1807 at 28-42. Those assets are USWD's right to publish directories on behalf of USWC and the associated opportunities, goodwill, reputation, and profits that derived from PNB's position as a regulated telecommunications service provider. In Order No. 89-1807, we determined that those assets belong to USWC's ratepayers.

In UT 85, Order No. 89-1807, we adopted a revenue retention ratio for determining the amount of directory revenues to impute to PNB. The ratio is derived by determining directory expenses as a percentage of USWD's net revenues (i.e., gross revenues less uncollectibles) and then imputing the remaining percentage of USWD's net revenues (directory profits) to USWC. Order No. 89-1807 at 29-30. Also in Order No. 89-1807, we adopted a 4.1% growth adjustment for PNB, because "the evidence indicates that there is a substantial likelihood that growth in directory revenues will equal or exceed 4.1% in the foreseeable future." At 41-42.

In UT 80, Order No. 91-1598, we adopted an Alternative Form of Regulation (AFOR) plan for USWC. As part of the plan, the utility agreed that

> [it] will not challenge, through legislation or litigation, the Commission's authority to impute Yellow Pages revenues for ratemaking purposes. This agreement is binding for the five-year term of the Plan and for five years after the end of the Plan. However, USWC is not prohibited from challenging the methodology and amount of imputation after the term of the Plan has expired.

Order No. 91-1598 at 8-9. On May 1, 1996, the Commission terminated the AFOR plan by Order No. 96-107. The five year post AFOR period during which USWC is prohibited from challenging our authority to impute Yellow Pages revenues for ratemaking purposes runs through April 30, 2001.

Despite this agreement, USWC spent considerable time at hearing and in its briefs arguing against the rationale for imputing Yellow Pages revenues, against the legality of such imputation given the Telecommunications Act of 1996, and against the policy of imputation in the current deregulatory, procompetitive climate.

We will not address USWC's arguments about the rationale for Yellow Pages imputation. We believe we have set out our arguments clearly in the orders cited above. The directory publishing assets belong to the ratepayers. The ratepayers should be compensated for the profitable enterprise that PNB transferred out of its regulated operations.

As to USWC's legal arguments, we find them to be not only direct challenges to the Commission's authority to impute Yellow Pages revenues for ratemaking purposes, in violation of the AFOR provision quoted above; we also find them to be incorrect. We address them summarily.

USWC argues that the Telecommunications Act of 1996 requires that universal service support mechanisms be competitively neutral or they are subject to FCC preemption. 47 USC §253. The record in this case does not indicate that Yellow Pages imputation supports universal service entirely. Instead, it shows that profits from Yellow Pages are used to meet USWC's total revenue requirement. It is also premature to claim that USWC's local rates would be subsidized illegally as a result of imputation, because the Commission will not decide on particular service rates until the end of the rate design phase of this case. Finally, USWC in its comments to the FCC in FCC docket No. 96-98 raised the directory revenue imputation issue. The FCC did not adopt USWC's suggestion that state imputations of directory revenues be preempted. *See* FCC Order 96-325 (the Interconnection Order).

Even if directory revenue imputation were prohibited by the universal service provisions of the Act or by the provisions prohibiting barriers to competition, which USWC also argues, we would not simply allow USWC's shareholders to keep the directory profits. Ratepayers would have to be compensated for the valuable intangible assets (directory publishing rights, opportunities, reputation) that USWD has acquired in connection with USWC's position as a regulated telecommunications service provider.

USWC argues that it is unfair to use revenues from an advertising business conducted by another company, which never even appear on USWC’s books, to depress USWC’s retail rates. This plaint ignores the historical relationship of PNB and the directory assets, which we have determined belong to ratepayers.

USWC contends that ORS 759.050, the Competitive Zone statute, prohibits directory revenue imputation. USWC reasons that imputation creates a subsidy of the utility’s local residential telephone rates, which will inhibit competitive entry. We do not consider imputation a subsidy, as we have stated, but compensation for assets that belong to ratepayers. Moreover, we note that although a number of potential competitors of USWC in the local exchange market have intervened in this docket, they have been silent as to the detrimental effects of directory revenue imputation on local competition.

USWC asserts that ORS 759.030(5) prohibits directory revenue imputation. This argument was considered and rejected by the Commission in UT 85, Order No. 89-1807 at 12-13, and will not be addressed again here.

USWC maintains that directory revenue imputation is prohibited by 47 USC §254k. That section provides:

> SUBSIDY OF COMPETITIVE SERVICES PROHIBITED. A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The [Federal Communications] Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

This section does not apply to directory revenue services, which are nonregulated services legally subject to competition. USWC errs in relying on Staff’s factual assertion that USWD dominates the directory publishing industry in Oregon.

Finally USWC argues that directory revenue imputation trenches on USWD’s free speech rights. USWD, a separate entity from USWC, is not a party to this proceeding. USWC has no standing to assert USWD’s rights here. Moreover, even if USWC did have standing, the First Amendment argument is meritless. USWC asserts that imputation, by extracting a subsidy from the directory advertising business, deters the exercise of the expressive and creative activities in that business. The implication is that absent imputation, USWD would more aggressively increase its Yellow Pages revenues, concomitantly exercising editorial creativity and the expression of ideas. As we have stated many times, imputation compensates USWC ratepayers for use of assets that belong to them. If USWC feels that this arrangement impedes its affiliate’s creativity and expression, USWC and its affiliate should arrange for some other form of compensation for ratepayers. The First Amendment does not contemplate uncompensated use of another’s assets in the exercise of editorial creativity or the expression of ideas.

In the present case, USWC proposes a directory revenue imputation amount of $34,829,500 for the test year. This is the amount the Commission has imputed to USWC annually since January 1, 1992. Staff, arguing that USWD’s Oregon revenues have grown substantially since 1992, recommends an imputation amount of $[deleted text not readopted]. Staff calculated this amount by applying the [****] percent directory revenue retention ratio approved by the Commission in UT 85 to USWD’s 1995 Oregon net revenues of $[****].

USWC contends that the following sources of directory revenues should not be imputed to it: sale of advertising to non USWC subscribers (national advertisers); [deleted text not readopted]; and recycling of directories. We reject this argument. These sources of revenues exist because USWC provides local

> telecommunications service. Regardless who purchases an advertisement, the point is to sell whatever is advertised to the subscribers of USWC, who receive the telephone directory. The value of the directory is directly linked to the regulated operations of the telephone company. Revenues from [deleted text not readopted] directory recycling also arise in connection with USWC's directory publication and distribution obligations as a regulated telephone company.
>
> [Deleted text not readopted] USWD's financial worksheets for 1995 show that its Oregon net operating revenues after expenses were greater than Staff's recommended imputation amount.[17] Moreover, the factors relevant to the retention ratio have either not changed or have improved for USWD in Oregon. USWD still dominates the directory publishing market, with more than an 80% share. USWD's rates for advertisements have increased faster than the rate of inflation. USWD's Oregon revenues, net operating revenues, and net income have grown steadily since 1992 and USWD's returns on equity are very high. [Deleted text not readopted]

Issue 3b: U S WEST Direct Directory Revenue Growth. The discussion on page 43 of Order No. 97-171 is readopted, but the amount in Appendix A, Column 16a, is amended to reflect the $0.3 million reduction in growth due to exclusion of foreign directory revenues and the change in retention rate.

> Staff recommends a directory revenue growth adjustment[deleted text not readopted]to Account 5230 (Directory Revenues) for the period rates resulting from this proceeding are expected to be in effect. This amount is 3.8% of the 1995 base directory revenue amount [deleted text not readopted], which equals the 6.8% growth, figured as a geometric average, of USWD's Oregon net directory revenues between 1992 and 1995, less the 3% access line growth adjustment Staff advocates in Issue 8j, Access Line Growth. Staff used August 31, 1997, the midpoint of the 32

[17] This assumes that a confidential amount in unspecified U S WEST Inc., budgeted (not actual) expenses allocated to USWD's Oregon operations were proper costs. There is some indication that USWD's Oregon costs for 1995 may be inflated by unidentified "other general and administrative expense." There is also some indication that USWD underreported its Oregon revenues.

month period when rates are expected to be in effect, to calculate the directory growth adjustment.

Staff argues that its directory revenue growth adjustment is reasonable in light of USWD's consistent record of directory revenue growth since 1992 and of the forecasts of outside financial analysts. Staff notes that USWD continues to dominate the directory publishing markets in Oregon. In 1995, USWD's publishing revenues grew by 7%; in second quarter 1996 they increased by 8% compared to the same period in 1995. For third quarter 1996 they increased 7% over against the same period in 1995. USWD also experienced a 4% increase in revenues per advertiser. Finally, Oregon is one of the ten fastest growing states in the nation, and USWC is facing strong demand for its telecommunications services in Oregon.

USWC argues that Staff's growth adjustment is onesided because Staff did not include any expenses in the adjustment. Staff responds that directory expenses are factored into the revenue retention ratio [deleted text not readopted], which Staff has used in this rate case. The ratio determines directory expenses as a percentage of USWD's net revenues. Only USWD's profits are imputed to USWC. Staff notes that USWC did not prove that USWD's future expenses for Oregon directory operations will be greater than the expense amounts factored into Staff's revenue retention ratio. As USWD's Oregon directory revenues grow, the amount of expenses incorporated in the retention ratio increases by a percentage of the revenue increase equal to 100 minus the retention ratio.

We adopted a 4.1% growth adjustment for PNB in UT 85, Order No. 89-1807, because of substantial likelihood that growth in directory revenues would equal or exceed 4.1% in the future. The same reasoning applies here. The evidence strongly points to continued growth for USWD directory revenues. Staff's proposal of 3.8% is conservative given USWD's growth to date. We adopt Staff's proposed growth adjustment. USWC's argument that Staff's calculation failed to include expenses is mistaken.

Issue 4, Affiliated Interests and Corporate Allocations. The Issue 4 adjustments at pages 44-59 of Order No. 97-171 are readopted.

ISSUE 4: AFFILIATED INTERESTS AND CORPORATE ALLOCATIONS

Completely Settled Issues:

- *Issue 4c, Strategic Marketing (Adjustment 19).* Staff and USWC agree to restate expenses to recognize the break up of Strategic Marketing. Appendix B, First Stipulation, Paragraph 4.

- *Issue 4d(3), Affiliated Interest Charges (Adjustment 20b).* Staff and USWC agree to remove charitable contributions, dues and memberships, lobbying and certain other affiliated interest charges. Appendix B, First Stipulation, Paragraph 5.

- *Issue 4g(1), Part 64 Still Regulated (Adjustment 23).* The FCC deregulated certain services and required below the line accounting. That is, nonregulated and nonoperating income amounts are shown below the net operating income line on the income statement. Some of these services remain regulated in Oregon. Staff and USWC agree on amounts to add back, but disagree about whether revenues should be imputed to render these services revenue neutral (Issue 4g(2)).

Significantly Undisputed Issues:

- *Issue 4e, Affiliated Interest Return Component (Adjustment 21).* Staff and USWC agreed to remove the rate of return that USWC had recorded in excess of the midpoint of Staff's rate of return range. For the final adjustment, Staff and USWC agreed to use the rate of return authorized in this docket. The final amount therefore depends on the resolution of Issue 2c, Cost of Equity. Appendix B, First Stipulation, Paragraph 6.

- *Issue 4f, Headquarters Allocations (Adjustment 22).* Staff and USWC agree to (a) restate the test year to reflect the corporate allocation factors that became effective January 1, 1996, and (b) consider the effects of the exchange sales that occurred after the development of the factors that become effective January 1, 1996. The final amount depends on the resolution of disputed expense issues. Appendix B, First Stipulation, Paragraph 7.

- *Issue 4h, Nonregulated Costs Removed in Columns 18-21 (Adjustment 23b).* Staff's test year is based on total Oregon data subject to separations. However, three of Staff's adjustments contain small amounts of unregulated costs, which Staff has removed. Staff and USWC agree that this adjustment should be made if the Commission adopts Staff's adjustments in Issues 4b through 4e, affiliated interests. Therefore, the final amounts depend on the resolution of Issues 4b through 4e.

Disputed Issues:

- *Issue 4a, Rent Compensation Study (Adjustment 17).* Staff and USWC agree on this adjustment except that USWC disagrees that the Commission should disallow any costs related to square footage. Staff and USWC agree to replace the rent compensation carrying charge (a reduction to Miscellaneous Revenues) with rate base and expense amounts. The final amount also depends on the resolution of Issue 2c, Cost of Equity. In calculating the carrying charge, USWC used an overall company achieved rate of return of 10.81 percent. Staff recommends using the midpoint of the authorized rate of return range. The final amount also depends on the resolution of Issue 4b (UM 753 Lease Expenses) and the final allocation factors from Issue 4f (Headquarters Allocations).

Staff made the following adjustments to the July 1995 Rent Compensation Study:

  - Removed 3.8958 percent of the headquarters, centralized and cross boundary amounts. This percentage represents the nonregulated portion.

  - Adjusted the headquarters and centralized rent compensation floor space to reflect a composite amount of 300 square feet per employee.

  - Adjusted the headquarters and centralized allocation factors based on labor dollars to reflect the UP 96 sale of exchanges to Telephone Utilities of Eastern Oregon, Inc., d.b.a. PTI Communications.

  - Adjusted the operating rent amounts to reflect adjustments prepared by Staff in Docket UM 753.

- *Issue 4b, UM 753 Lease Expenses (Adjustment 18).* Four leases were moved from docket UM 753 for litigation in this docket, and Staff has adjusted expenses accordingly. Staff also reduced lease expenses to reflect Order No. 96-179 in UM 753.

- *Issue 4d(1) and 4d(2), Fax Services (Adjustments 20-20a).* Staff argues that fax services are regulated telecommunications services under the Commission’s jurisdiction. Staff therefore restated revenues to recognize the June 1, 1995, service agreement.

  Staff also increased the revenues to reflect the level expected during the period when rates from this docket will be in effect. USWC considers these fax services issues to be growth adjustments outside the test year. Staff disagrees; it argues that Issue 4d(1) is a normalizing adjustment.

- *Issue 4d(4), FCC License (Adjustment 20c).* Staff restated the test year to recover the value of an FCC license sold by USWC. USWC disagrees with Staff's adjustment, arguing that it was already included in a rate case.

- *Issue 4g(2), Part 64 Still Regulated Revenue Imputation (Adjustment 23a).* USWC disagrees that revenues should be imputed to render these services revenue neutral. If the Commission includes Staff's revenue imputation adjustment, then Staff and USWC agree that the final amount depends on the resolution of Issue 6c, Tariff, Price, and Contract Changes. The final amount also depends on Issue 2c, Cost of Equity.

Issue 4a: Rent Compensation Study – Excess Building Space

USWC has telephone operations in fourteen states, of which Oregon is one. Within those states, USWC houses headquarters and centralized employees with multistate job functions and duties. Because of the multistate nature of the functions, USWC must perform studies to allocate the associated costs among the states it serves.

Staff proposes to adjust USWC's state composite headquarters and centralized employee space allowance to 300 square feet per employee. Staff's position is that building space expenses should be recognized in rates only if the expenses are reasonable. Staff's purpose in making the adjustment was to ensure that Oregon ratepayers do not bear costs for excess building capacity. Staff's adjustment would decrease USWC's proposed total Oregon rate base by $2,151,561 and total Oregon operating expenses by $735,484.

To establish its standard for square feet per employee, Staff compared USWC's rent compensation studies for 1992 and 1995. In its rent compensation study, USWC adjusts total building costs to remove nonadministrative space.[18] Staff determined that USWC's square footage per employee increased from 309 in 1992 to 347 in 1995. Total employees in the studied locations decreased by 6,284 from 1992 to 1995, but the number of headquarters and centralized employees at the studied locations increased by 7,785 during the same period.

Staff determined that the ratio of headquarters and centralized employees to total employees in a building is increasing, as is the square footage per employee. Staff concludes that with these increases, more dollars are assigned to the headquarters and centralized category for allocation among the 14 states. Staff argues that the increase in square feet per employee indicates that there is idle capacity and the fixed costs associated with it are being passed through for recovery in rates.

Staff notes that it selected 300 square feet per employee as a reasonable amount because that was approximately the amount calculated from the 1992 rent compensation study and because it was a conservative amount, being more than the Building Owners Management Association (BOMA) recommendation of 250 to 270 square feet per employee and more than the Public Utility Commission building use of 278 square feet per employee. Staff believes that because the 1995 study captures USWC's reorganization and downsizing, the proposed adjustment more accurately represents where USWC's building cost level will be during the time rates are in effect.

USWC argues that the Commission may not disallow the expenses in question without a showing that they have been imprudently incurred. USWC notes that Staff does not claim that USWC acted imprudently in acquiring or failing to dispose of building space. USWC maintains that it made a

[18] To achieve this, USWC deducts from total usable space vertical penetration (stairwells, elevator shafts), core areas (restrooms, lobbies, corridors, mechanical rooms), network equipment space, space rented to affiliates, third-party leased space, and computer space to arrive at administrative space.

good faith decision to acquire space when it was needed, and that it should now be allowed to recover costs for idle building space just as it is allowed to recover other telephone investment.

USWC also argues that Staff's calculation of square footage relies on USWC's rent compensation studies, which were designed to allocate building investment and lease expense for space used in providing service for more than one state. The data in those studies, USWC maintains, were not collected to measure average floor space per employee, and the studies do not use the BOMA definition of usable administrative space. Therefore, USWC argues, Staff draws incorrect inferences from the study and makes comparisons to external measures that Staff cannot show to be reasonably comparable. USWC contends that space for parking and cafeterias is included in its rent compensation studies but not in the external measures Staff uses, while contract employees and employees of vendors are not included in Staff's calculations, although they are present in USWC's buildings. USWC argues that these factors result in an overstatement of the company's space per employee. USWC argues that, taking these factors into account, its "usable administrative space" is within Staff's 300 square feet per employee standard.

USWC also charges that Staff's 300 square feet per employee standard is arbitrary. Staff responds that it did not set the 300 square foot per employee limit solely based on the Commission building or the BOMA standards. Staff used those external comparisons only as guidelines. If it had, the limit could have been 270 or 275 square feet per employee. Instead Staff set the limit at 300 square feet, which, it argues, accommodates the existence of contract employees.

USWC notes that it provided actual data for its major buildings that should be used for this analysis, rather than the inapplicable rent compensation study. USWC asserts that its affiliate Business Resources, Inc., (BRI) tracks usable administrative square feet for major buildings, and this tracking shows the major building space per employee to be 269 square feet in September 1996. USWC Exhibit 75 summarizes BRI's results. This information, according to USWC, is traced in a manner consistent with the BOMA definition of usable space.

Staff contends that this exhibit omits minor buildings, which constitute about one third of USWC's total headquarters and centralized employee space. The average square footage per employee in the 1995 rent compensation study for minor buildings exceeds the average for major buildings by 48 square feet.[19] Staff argues that USWC Exhibit 75 does not establish USWC's reasonable use of "minor building" space or that its total composite state building space is reasonable.

Second, Staff notes that USWC Exhibit 75 contains no comparison with July 1995. Staff points out that a comparison of Exhibit 75 and the July 1995 rent compensation study shows that headquarters employees increased from 26,049 in 1995 to 31,830 in USWC Exhibit 75. Staff argues that the increased concentration of headquarters employees in major buildings may have decreased the major building square footage per employee found in September 1996.

Moreover, Staff responds that USWC fails to recognize that the initial basis for Staff's adjustment was the comparison between the 1992 and the 1995 rent compensation studies. If the studies include any space that deviates from what would be included under the BOMA standards, this is largely irrelevant, Staff contends, because the additional space would be included in both the 1992 and the 1995 calculations. Staff gives weight instead to the increase in square feet per employee, which it contends is attributable to excess building capacity.

USWC responds that the Commission should give more weight to Exhibit 75 than to the rent compensation studies figures. First, the company

[19] According to Appendix D to Staff's Opening Brief, at 4, USWC's response to Data Request 89, the 1995 building study, indicates that the major buildings have a square footage per person average of 332, while the minor buildings average 380 square feet per person.

argues that Exhibit 75 measures according to BOMA standards, so that it is clear what is included and what is excluded. Second, USWC adds the 48 square feet by which the minor buildings exceed the major building average in Staff's Appendix D to the 269 square foot average for the major buildings in Exhibit 75 to arrive at an average for the minor buildings of 317 square feet. USWC then weights this figure, multiplying the major buildings' 269 square feet by 67% and the minor buildings' 317 square feet by 33%, which yields a composite 285 square feet per employee.[20]

Disposition. We accept Staff's calculation of 300 square feet of administrative space per employee in headquarters and centralized buildings as reasonable. However, we believe that the record is unclear with respect to what the rent compensation studies include. Staff notes that the figures do not include contract workers, but argues that its 300 square foot figure is conservative enough to accommodate such workers. However, Staff does not answer USWC's contention that the rent compensation studies include space for parking and cafeterias, whereas the external measures do not.

Staff seems to argue against an adjustment based on Exhibit 75 because during the test year the square footage per employee in headquarters and centralized buildings could have exceeded 300 square feet. However, as we stated in the discussion of Issue 1A, the function of a test year is to represent expenses during the time rates will be in effect. Staff notes that the 1995 rent compensation study captured a point at which USWC had not completed its plan to position itself for competition. Therefore, we find it appropriate to consider the 1996 data represented by Exhibit 75. Not only do those data reflect a later period, in which we may assume that USWC has progressed in its plan for competition; we

[20] USWC also calculates the minor building average square footage on a percentage relationship. The rent compensation study gives 380 square feet as average for the minor buildings, which is 14% greater than the 332 square feet for the major buildings. Applying the same percentage relationship to the BRI major buildings yields 308 square feet for the minor buildings. If these figures are weighted by percentage, the composite is 282 square feet.

also have better assurances that those data reflect only administrative space.

Following USWC's calculation of minor and major building square footage per employee, we conclude that USWC's average square footage per employee in headquarters and centralized buildings is under 300 square feet. USWC's rent expenses are, therefore, reasonable and will be allowed.
We note that our decision on this issue is limited to the facts before us. Where the use of space changes, we will not automatically approve continued expense. We approve the expenses in this issue because we find them reasonable.

Issue 4a and 4b: Lease Expense

Staff proposed adjustments for various aspects of USWC's lease expense for certain identified properties. USWC stipulated to each adjustment except for the one concerning the property called "1201 Farnham." At issue is the allocation of space at that property between office/administrative space and lab/computer space. The allocation is significant, because lab/computer space is more expensive than administrative space.

From a consultant's study provided by USWC, Staff determined that the Farnham space should be allocated roughly 80% to office use and 20% to computers. Staff proposes to disallow $243,013 of lease expense for this property on a system wide basis. The Oregon share of this disallowance is approximately $20,000. USWC claims that these percentages should be reversed. With its reply testimony USWC submitted an exhibit, USWC Exhibit 79, which USWC alleges shows the actual configuration of the property. USWC argues that Staff's allocation of space should have been revised in view of these actual data about the building's composition. USWC contends that it is arbitrary and capricious of Staff to ignore the actual evidence of its second exhibit.

Staff responds that it took the first data USWC submitted, the consultant's study, to be actual data with respect to the configuration of the Farnham property, and that the second document

USWC submitted conflicted with the first. Staff further asserts that it had not had a fair opportunity to analyze, verify, and possibly normalize the data in the second document. Moreover, Staff argues, Exhibit 79 was not supported by any documentation.

Disposition. We conclude that USWC's evidence is insufficient to show that the actual configuration of the Farnham property is dedicated roughly 80% to lab/computer functions and 20% to administrative functions. It is reasonable for Staff to rely on the evidence USWC first submitted, because Staff has not had a reasonable opportunity to examine the second document USWC submitted, which conflicts with the first. If USWC can document its new numbers for the Farnham property, the lease expense should be higher in the next rate case.

Issue 4d(1): Fax Services

Staff recommends increasing Account 5260, Miscellaneous Revenue, by $137,200 to account for revenues USWC receives from CSC Intelicom, Inc., (CSC) in conjunction with the provision of facsimile (fax) services. Staff takes the position that fax service is a regulated telecommunications service and that USWC is jointly providing fax services with CSC.

USWC argues that the Commission has no jurisdiction to regulate fax services. The company further argues that it is not providing fax services but merely providing marketing support for CSC, which owns the hardware and, according to USWC, controls the provision of the services.

USWC also argues that Staff's position on this issue is inconsistent with the position it takes on Issue 4g, Part 64 Still Regulated. Finally, USWC argues that Staff's adjustment is incorrectly calculated.

Service Provision. The contract between CSC and USWC is a confidential exhibit (Staff 81). The contract confirms USWC's claim that CSC owns the hardware involved in provision of fax services, and USWC is responsible for marketing. However, the contract reveals that USWC is also responsible for controlling significant aspects of the fax service provided over its telephone lines. We conclude, therefore, that USWC is jointly providing fax service with CSC.

Jurisdiction. Staff argues that the Commission has jurisdiction over USWC's provision of fax services because we have jurisdiction over the service a utility provides. Staff cites to Order No. 89-1807 (UT 85) at 9-13 (discussion of Commission jurisdiction over directory revenues).

USWC argues that the Commission has no jurisdiction over the provision of fax services. USWC argues that the FCC has deregulated fax services and that they should therefore not be regulated by the Commission. USWC also argues that since fax services are generally not regulated by the Commission, the fax services USWC provides with CSC should also not be regulated. USWC rebuts Staff's argument of jurisdiction by arguing that the Commission's conclusion that it had jurisdiction over directory revenues in Order No. 89-1807 was based on a finding that the directory was a facility used in conjunction with voice communications. USWC contends that there is no evidence in the record that fax services are used in the same way with reference to voice communications.

We conclude that it is irrelevant that the FCC has deregulated provision of fax services. Unless the FCC preempts state regulation, that regulation remains a matter for the states. See, e.g., the discussion of Part 64 Still Regulated, below.

The discussion in Order No. 89-1807 does not rely on a relationship between a service and voice communication for a finding of jurisdiction. Instead, at 10, it sets out the definition of "service" in ORS 756.001(12), which provides that "service" shall be used "in its broadest and most inclusive sense and includes equipment and facilities related to providing the service or product." The order concludes that "the Commission possesses authority over not only the provision of natural gas, electricity, telephone messages, and the like, but also over those ancillary services which are closely related to the provision of public utility service." *Id*. The definition of "telecommunications service" or "service" in OAR 860-032-0001(10) supports the position that we have jurisdiction over fax services. That definition reads in part: "'[S]ervice' means two-way switched access and transport of voice communications, and all services provided in connection with such services . . . ."

Fax services are provided in connection with telecommunications services in that they employ telephone lines to transmit data. We conclude that we have jurisdiction over USWC's fax services.

Consistency of Staff's Position. USWC notes that in Issue 4g, Staff imputed revenues equal to the services' costs to keep them revenue neutral for purposes of this rate case. USWC argues that fax service is a Part 64 service and should also be revenue requirement neutral. However, Staff did not impute costs for fax services.

Staff responds that its adjustment in Issue 4g is not a global adjustment for all Part 64 Still Regulated services, but applies only to specific services. This argument is set out in greater detail in the discussion of Issue 4g below.

We conclude that Staff is correct in its argument. Staff has recommended imputation of revenues for five enhanced services that are underearning. Fax services are not underearning and are, therefore, not included in the Part 64 group of services in Issue 4g.

Calculation of Staff's Adjustment. USWC asserts that the $137,200 imputation for fax services is too high because it does not include actual costs. The company also contends that the test period is flawed, because it contains 20 months rather than 12. Finally, USWC suggests that the $137,200 may contain interstate revenues.

Staff replies that USWC witness Carl Inouye stated on cross examination that the company had not provided cost information to Staff on fax services. Staff argues that the test period for fax revenues is correct. Staff used USWC’s fax revenue estimates for post-June 1995, 1996, and part of 1997. Staff argues that the test period is not overstated. In fact, Staff reduced the level of 1996 and 1997 fax revenues in its adjustment because USWC had failed to meet its own revenue projections for 1995.

Staff notes that its adjustment accounts for interstate revenues because Staff uses a separations factor to separate intrastate revenues from interstate revenues on all adjustments. Staff also notes that it used the company’s own numbers to calculate the adjustment.

Disposition. We are persuaded by Staff’s arguments. We conclude that the adjustment for fax services Staff has proposed is reasonable and should be accepted. The revenues from fax services will be imputed to USWC.

Issue 4d(2): Growth in Fax Services

Growth Adjustment. Staff recommends an increase of $807,100 to Account 5260 to account for growth in fax services for 1996 and 1997. Staff points out that it reduced the level of 1996 and 1997 fax revenues in its adjustment because the company had not met its revenue projections for 1995. USWC opposes a fax services growth adjustment for the same reasons it opposes other adjustments to the test year. That is, USWC argues that the adjustment distorts the test year by failing to include expense or investment involved in generating the revenues at issue. USWC witness Inouye testified that because of its disagreement with Staff over test year construction, USWC did not intend to provide cost estimates for 1996 and 1997. Tr. 321-22.

Disposition. We support Staff’s growth adjustment for the same reason we support other growth adjustments (see, e.g., discussion of Issue 3b above and 8j below). These adjustments make the revenues representative of the time that the rates from this docket are likely to be in effect.

USWC cannot both refuse to submit cost estimates and complain that Staff fails to include revenues and expenses in its test year adjustments. USWC has the burden to show that its costs are reasonable. ORS 759.180(1). Staff's growth adjustment is fair and reasonable and should be accepted. The revenues from fax service growth will be imputed to USWC.

Filing a Tariff for Fax Services. USWC currently offers fax services without a tariff. Staff asks the Commission to order USWC to file a tariff for fax services and to properly record the fax service revenues in the appropriate account.

Disposition. In view of our conclusion that we have jurisdiction over USWC's provision of fax services, we conclude that USWC must file a tariff for its fax services and record its fax service revenues in the appropriate above the line account. If USWC wishes to petition to have fax services deregulated, it may do so pursuant to ORS 759.030.[21]

Issue 4d(4): FCC License

Staff proposes a $448,185 increase in total Oregon miscellaneous revenues to account for the value of an FCC license that USWC (then Pacific Northwest Bell, PNB) sold to U S WEST NewVector Group, Inc., (NVG), an affiliated company.

In Order No. 90-1516, the Commission approved a sale of paging service assets by USWC to NVG. The assets included an FCC license. Staff takes the

[21] USWC argues that if the Commission orders USWC to file a tariff for its fax services, under the Equal Protection clause, we must also order the same for the hundreds of other sales agents who do precisely the same thing that USWC does with fax services in Oregon. We disagree for two reasons. First, we have found that USWC is not merely a sales agent but a coprovisioner of fax services. Second, USWC is a regulated utility subject to Commission jurisdiction over its telecommunications services and services provided in connection with those services. See discussion at Issue 4d(1) above. That is not the case with the hundreds of other sales agents operating in Oregon.

position that Order No. 90-1516 did not place a value on the FCC license, but left to "the next rate case" the issue of valuation and ratemaking treatment of the license. Staff has now calculated a value for the FCC license.

USWC takes issue with Staff’s determination that the value of the license should be part of UT 125 and with the calculation of the value of the license.

Order No. 90-1516 approving the transfer of paging assets from PNB to NVG contains a stipulated settlement with regard to the transfer. The settlement provides, in relevant part:

1. Staff and ORCCA [Oregon Radio Common Carrier Association] recommend that the Commission approve both parts of PNB’s application based upon PNB’s agreement to conditions 2 through 7.

2. PNB will transfer the paging assets to NewVector at net book value determined as of the date of the Commission Order adopting the Settlement Stipulation.

3. NewVector will make an additional one time payment to PNB in the amount of $135,400.

4. PNB will recognize the $135,400 payment it receives from NewVector on its books of accounts as a liability.

5. The Commission shall determine the appropriate treatment of this liability described in No. 4 during PNB's next rate case.

Order No. 90-1516, Appendix A at 2. The Commission adopted the terms of the stipulation.

The sum of $135,400 in addition to net book value of the paging assets represented the present value of an annual payment of $28,443 for 10 years. $28,443 was Staff's estimate of PNB's 1989 net revenue from the paging service; 10 years corresponded to the remaining life of the existing assets. *Id*. The purpose of the $135,400 payment in addition to the transfer of the net book value amount was to compensate the utility for the potential loss of revenue resulting from the paging asset transfer. Staff argued that the two components, net book value of the assets and compensation for potential revenue loss, gave a reasonable approximation of fair market value. *Id.*, Appendix A at 8 (testimony of Staff witness E. Michael Myers). Mr. Myers characterized this mechanism for approximating fair market value as one "by which the sale of the utility property which is the subject of UI 90/UP 53 is fair and reasonable and not contrary to the public interest." *Id.* at 7.

Staff argues that the $135,400 was merely a placeholder for the minimal value of the paging assets and was to be revisited in the next rate case, at which time a more accurate value for the FCC license would be substituted for the placeholder value. Based on conversations with Staff members involved in the docket that resulted in Order No. 90-1516 (UI 90), Staff witness Marion Anderson concluded that Staff had been unable to assign a fair market value to the FCC license, because no market information was available. Therefore, he testified, the issue was put aside to be dealt with later.

Staff asserts that its calculation of the value of the FCC license, while likely not correct, is flawed due to USWC's failure to provide necessary information for the valuation to be accurately computed. Finally, Staff argues that UT 125 is the "next rate case," rather than UT 102, as USWC asserts.

USWC argues that Staff's proposed adjustment would violate the terms of the settlement agreement set forth above. USWC argues that according to the plain language of the settlement, the only issue preserved for the next rate case was the ratemaking treatment of the $135,400 payment. USWC submits that that amount may not be reevaluated and reset in this docket. USWC points out that the radio licenses transferred in Order No. 90-1516 were specifically listed in the application seeking Commission approval; the option of reevaluating the FCC license was therefore not preserved by silence. Moreover, USWC notes that in the first paragraph of the stipulation, Staff specifically recommends that the Commission adopt both parts of PNB's application. That recommendation includes the FCC licenses.

USWC points out that with Staff's concurrence, the $135,400 was returned to ratepayers along with approximately $4.9 million in Ballot Measure 5 property tax savings, as a one time refund in the January 1995 billing cycle.

Disposition. According to Mr. Myers' testimony in support of the stipulated settlement of Order No. 90-1516, Staff believed it had found a mechanism for treating the transfer of paging assets, which included the FCC license, in a way that was fair and reasonable and in the public interest. Rather than being a placeholder value, the order at 3 and Mr. Myers' testimony show the figure to be the calculation of an income stream from the paging assets with the purpose of replacing revenues lost due to the transfer. The record shows that the paging assets were carefully valued. Order No. 90-1516 at 3.

We do not read either the stipulation or Mr. Myers' testimony to preserve the reevaluation of the $135,400 in Paragraph 4. The agreement gives a liquidated amount for the liability mentioned in Paragraph 5. The only undetermined issue with respect to the asset transfer is what ratemaking treatment the amount is to receive. Whether UT 102 or UT 125 is the appropriate forum for that decision is moot, since the issue was resolved by a one time refund in 1995.

We conclude that Staff's proposed adjustment should not be accepted.

Issue 4g(2): Part 64 Still Regulated

Part 64 refers to the FCC regulations codified at 47 CFR Part 64, Subpart I, §§64.901 through 64.904. These regulations govern the allocation of costs between regulated and nonregulated activities. Oregon has adopted similar cost allocation standards at OAR 860-027-0052 and OAR 860-035-0050. The allocation of joint and common costs between regulated and nonregulated operations under Part 64 is designed to prevent regulated ratepayers from supporting the costs of providing nonregulated services. Services purchased by the nonregulated operations from the regulated operations are purchased at tariffed rates. The remaining joint and common costs are allocated, to the extent possible, on a directly assigned or attribution basis. Only costs with neither direct nor indirect measures of attribution, such as certain general office expenses, are allocated on a general allocator, which is based on the expenses previously allocated by direct assignment or attribution.

Currently, enhanced services[22] are subject to Part 64 allocation. Part 64 deals with five

[22] OAR 860-035-0020(13) defines "enhanced service" as:

> a service which employs computer processing applications that act on the format, content, code, protocol or similar aspects of the

categories of enhanced services, only two of which concern us here: services that have never been subject to federal or state tariff regulation, such as video dialtone, and federally deregulated services that remain regulated by the state jurisdiction.

The USWC services that are deregulated in the interstate jurisdiction but still subject to regulation in the state jurisdiction and subject to Part 64 allocation are:

1. Protocol Conversion: converts data transmission protocols in cases where the originating protocol is different from the terminating protocol.

2. Customer Dialed Account Recording (CDAR): allows customers to identify call billing details to various customer assigned account codes for their own internal purposes.

3. Voice Messaging Service (VMS): allows a customer to maintain a voice mail box to record, save, and retrieve phone messages.

4. Video Dialtone Service (VDT) (currently renamed Open Video Systems (OVS)): provides for broadband network deployment for interactive video and other multimedia customer services.

5. Planning for Enhanced Services: encompasses various planning and market research activities but primarily appears to target screenphone services that allow the customer to take advantage of advanced network call handling and messaging features.

Staff recommends that the Commission impute \$3,377,859[23] in total additional revenue for the

customer's transmitted information; provides the customer with additional, different, or restructured information; or involves customer interaction with stored information. . . .

[23] Staff originally recommended that the Commission impute \$3,472,397, then recommended reducing that amount by \$94,538 to eliminate double

five categories of Part 64 services, in order to render the five services revenue requirement neutral for purposes of this rate case.

Staff and USWC agree that under Part 64 attributable cost accounting methods, these five enhanced services individually and collectively earn less than their costs. USWC and Staff also agree on the financial impact of the services.

Staff does not recommend a global policy of imputing revenues for all Part 64 services. Staff recommends addressing other services on a case by case basis. The enhanced services for which Staff recommends imputation in this docket are all underearning, and each has a unique context. Therefore, we discuss the services one by one.[24]

1. and 2. Protocol Conversion and CDAR. Both of these services appear to be moribund. Protocol Conversion was canceled in December 1995, and CDAR is neither tariffed nor price listed currently. Both services involve minimal revenues. Staff argues that it is unreasonable to continue to support these dying services until the next rate case, and recommends imputation to render the services revenue requirement neutral.

3. VMS. Revenue for this service is significantly below cost. However, VMS is the fastest growing enhanced service. VMS regulation is addressed by the 1996 Telecommunications Act and subsequent FCC action. Section 260(a)(1) of the Act provides that a local exchange carrier "shall not subsidize its telemessaging service directly or indirectly from its telephone exchange service or its exchange access [service]." In its Order No. 96-490, ¶¶ 39-45, the FCC concluded that §260 extends to the prevention of improper cross subsidization related to intrastate service.[25] Staff argues that the VMS revenue imputation it

counting of new USWC voice message promotions should we approve Staff’s adjustment under Issue 6c. We approve Staff’s 6c adjustment and use the reduced figure here.

[24] Staff’s recommended imputation amount per service is confidential. ***See*** Confidential Staff Exhibit 11.

[25] We take official notice of FCC Order No. 96-490 pursuant to OAR 860-014-0050.

proposes will help USWC comply with the Act and the FCC order.

4. VDT/OVS. This service is in the planning and development stages, with a successful trial underway in Omaha, Nebraska. There is no Oregon revenue and no Oregon tariff for this service. Without a revenue imputation to render this service revenue neutral for this rate case, Staff argues that other services will in effect pay the test year VDT development costs in the amount Staff proposes to impute. This support would continue until the next rate case.

The 1996 Telecommunications Act addresses OVS at 47 USC §651 and 653. The FCC has published a Notice of Proposed Rulemaking (FCC Order No. 96-214[26]) indicating its intent to apply Part 64 cost allocation methods to protect regulated telecommunications services against cost misallocations due to the provision of OVS by local exchange carriers. In addition to the goal of ensuring that rates are just and reasonable, the FCC stated:

> We also seek to ensure, as mandated under Section 254(k) of the 1996 Act, that incumbent local exchange carriers do "not use services that are not competitive to subsidize services that are subject to competition." Order No. 96-214 at 12.

Staff argues that the Commission should not support the VDT/OVS venture with revenues from other telecommunications services and ratepayers. In the current environment, Staff contends, it is appropriate that this new venture stand alone. The simplest way to accomplish that, according to Staff, is top impute sufficient revenues to render VDT revenue requirement neutral for purposes of this rate case. Staff argues that this action would leave the Commission positioned to respond to either federal preemption of VDT/OVS or to a USWC petition to deregulate the service without having to consider potential ratepayer claims to profits from the service.

[26] We take official notice of FCC Order No. 96-214 pursuant to OAR 860-014-0050.

5. Planning for Enhanced Services. As is the case with VDT/OVS, there is currently no Oregon revenue for this service. Staff's proposed imputation amount is considerably less than for VDT/OVS, however. Staff acknowledges uncertainty about the actual use of the service. If the service addresses only advanced network calling features, then it would be directed at a still regulated service. On the other hand, if it focuses ultimately on screenphones, which are a type of customer premises equipment, then it is preemptively deregulated by the FCC. Given the uncertainty surrounding this service and its absence of Oregon revenues, Staff recommends rendering it revenue requirement neutral for purposes of this rate case.

Staff argues in favor of imputing revenues from these five services in order to prevent cross subsidy of these competitive services by services that are not subject to competition; i.e., basic service.

USWC contends that Staff is inconsistent in its position on imputation. On the one hand, USWC argues, Staff wants to impute Yellow Pages revenues to USWC. USWC views this imputation as a cross subsidy of basic service by directory revenues. On the other hand, USWC maintains that Staff justifies its recommended imputation in this issue by saying it wishes to prevent cross subsidy of enhanced services by basic service. USWC also argues that it is unfair to select out a group of services subject to competition and impute their revenues without subjecting all competitive services to the same imputation methodology.

USWC also objects to Staff's proposed imputation of revenues for the Part 64 services, in part because Staff applies the imputation on the basis of a fully distributed cost method instead of an incremental cost method. USWC argues that it is bound to price its services at incremental cost and Staff's imputation methodology is therefore unfair.[27]

[27] USWC also maintains that in Dockets CP1, CP 14, and CP 15, USWC's competitors argued that the company should be prevented from having

We find the imputation of Yellow Pages revenues a different matter from imputation of revenues from these services to make them revenue requirement neutral for purposes of the rate case. As we discussed in Issue 3a, Yellow Pages imputation gives ratepayers a benefit for the use of assets that belong to them. In our view, Yellow Pages imputation is a solution to the historical effects of divestiture and PNB's spinning off the directory publishing affiliate. That makes Yellow Pages imputation unique. We do not consider Yellow Pages imputation a subsidy.

The imputation at issue for the five Part 64 Still Regulated services is designed to prevent subsidies flowing from basic service to services that are a) subject to competition and b) underearning. Staff's recommended imputation is fair in two ways. It protects customers from paying rates that reflect costs of services that are not paying for themselves, and it shields USWC from eventual claims by ratepayers to profits or development costs for these services.

USWC objects to Staff's imputation methodology, which applies the imputation on the basis of a fully distributed cost method. We find Staff's method reasonable for the following reasons. First, there is no Oregon total service long run incremental cost or other measure of incremental cost for nonexistent services, such as Planning for Enhanced Services, OVS, Protocol Conversion,

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revenues granted in rate proceedings that could be used to support services subject to competition. USWC argues that the Commission rejected the competitors' arguments and reiterated its obligation to provide USWC with an opportunity to recover its capital and earn a fair rate of return. Order No. 96-188 at 98. USWC appears to have taken an argument out of context. The passage in question refers to the necessity of retaining a revenue requirement for the local exchange carriers as long as rate regulation is still in effect. The passage reads:

> AT&T, MCI, and ELI argue that the concept of a revenue requirement has no validity in a competitive environment. Revenue requirement calculation is necessary as long as LECs are subject to rate of return regulation. Although competition is emerging in telecommunications, we continue to have a constitutional obligation to regulate LECs in a manner that provides them a fair opportunity to recover their costs and earn a reasonable return. ***Duquesne Light Co. v. Barasch***, 488 US 299, 310, 109 S Ct 609, 102 L Ed2d 646 (1989).

or CDAR. Second, the FCC accounting rules and our own accounting rules provide that the fully distributed cost method should be used in accounting for these services. 47 CFR Part 64; OAR 860-027-0052; 860-035-0050. Finally, we note that Staff and USWC have stipulated to the financial impact of these services.

We conclude that Staff's imputation recommendation is reasonable in principle and applies the correct methodology. We accept Staff's recommendation on Issue 4g(2).

Issue 5, UP 96 Sale of Exchanges. The Issue 5 discussion at pages 59-62 of Order 97-171 is readopted.

ISSUE 5: UP 96 SALE OF EXCHANGES

Completely Settled Issues:

- *Issue 5b, Stipulation (Adjustment 25).* In docket UP 96, USWC agreed to use part of the gain on the sale as a rate base reduction. Staff and USWC agree on the intrastate effects, but the total Oregon amount depends on the final factors in Issue 10, Final Test Year Separation Factors. This has no effect on revenue requirement. *See* Appendix B, First Stipulation at Paragraph 10.

- Issue 5c, Effect on Property Taxes (Adjustment 26). Staff and USWC agree to include the property tax savings resulting from the sale of exchanges to PTI. *See* Appendix B, First Stipulation at Paragraph 11.

Disputed Issue:

- *Issue 5a, Sale of Exchanges (Adjustment 24).* Staff and USWC disagree on plant specific, plant nonspecific, customer operation and corporate operation expenses. Revenues, property taxes, rate base,

> and other expenses were stipulated. *See* Appendix B, First Stipulation at Paragraph 9.

In October 1995, USWC sold 23 exchanges totaling about 16,000 lines to Pacific Telecom, Inc. (PTI). The Commission approved the sale in Docket UP 96, Order No. 95-526. To normalize the test year to reflect the financial effects of this sale, Staff proposes a controllable expense reduction of $3.030 million. This adjustment includes labor expense reductions of $1.991 million and associated nonlabor expense reductions of $1.039 million.[28]

Staff's approach to normalizing the test year took three factors into account. First, in analyzing the financial impact of the sale, USWC estimated that the UP 96 controllable expense reduction would be about $3.0 million. Second, Staff used information USWC provided during the UP 96 docket to project controllable expense savings from the PTI sale at $2.998 million. Finally, Staff considered that USWC's Oregon direct employee count in 1995 dropped by over eight times the number of employees that Staff estimated were saved due to the UP 96 sale. Staff's approach is set out below.

USWC's estimate of controllable expense reduction. In developing its 1996 headquarters allocation factors, USWC computed savings due to the PTI sale. USWC estimated that UP 96 would effect a $2.5 million reduction in plant specific, plant nonspecific, and customer operations for ten months of 1995. USWC's estimate was based on average per line costs. Annualized, this estimate comes to $3.0 million.

Estimate of savings developed during UP 96. Staff compared USWC's savings estimate of $3.0 million with Staff's estimate of expense reductions in

[28] All other financial effects of the sale have been settled between Staff and USWC. The parties disagree on the amounts of adjustments for labor and associated nonlabor controllable expense components in Column 24, Lines 9 (Plant Specific), 11 (Plant Nonspecific), 14 (Customer Operations), and 16 (Corporate Operations) of Appendix A, p. 6.

the UP 96 case and found then nearly equal. Staff’s estimate of $2.998 million was based on a USWC financial model and information provided by USWC. In UP 96, USWC witness Carl Inouye testified that Staff’s estimate of savings was a reasonable estimate of the effect of the sale a year or so after the sale. Staff argues that its current estimate of UP 96 savings is thus consistent with the figures USWC presented to Staff during UP 96 and used in part to justify the sale as being in the public interest.

Employee reductions. Staff’s $2.0 million labor reduction component of the UP 96 savings is equivalent to a reduction of 1.9 managers and 37.6 craft employees. These numbers, Staff notes, are comparable to the information provided to Staff in UP 96. As part of its analysis, Staff considered the overall loss of direct Oregon USWC employees between December 1994 and December 1995 to help evaluate whether the estimated loss of UP 96 employees was reasonable. Staff determined that the actual direct employee loss in 1995 was over eight times the 40 employees attributed to the UP 96 sale, and concluded that the 40 employee figure was reasonable or even conservative.

USWC identifies its controllable expense savings from the sale of the 23 exchanges as being $157,207 (power costs of $107,057 and maintenance costs of $50,000). USWC argues that its ongoing expense level has not declined. It argues that any further adjustment, if allowed,[29] should be limited to recognizing elimination of four employees, a reduction of $.226 million in labor expense.

The testimony of Mr. Inouye indicates that the labor expenses associated with the four employees were the actual expense reductions associated with the PTI transfer.[30] But USWC witness Michael Solso, to whose testimony Mr. Inouye refers, testified on redirect that his purpose in the

[29] This characterization of USWC’s position is based on Mr. Inouye’s written testimony on UP 96 in this docket, which does not acknowledge the existence of the power and maintenance cost savings.
[30] See us Exhibit 55, Inouye 111.

rate case was to "identify the technicians that were associated with the sale of the exchanges." Tr 39. He identified six technicians, two of whom were redeployed.

Staff argues that not only did Mr. Solso fail to mention the acknowledged power and maintenance cost savings, or other savings such as plant and maintenance record savings, clerical and support staff savings, customer complaint savings, billing and collection savings, and fractional technical employee savings, he did not even address all the technicians who served the sold exchanges. Staff points out that the six technicians identified by Mr. Solso were located at staffed wire centers in Burns, John Day, and Heppner. Of the remaining 20 wire centers in the exchange, 15 were served by other employees. Those 15 exchanges were responsible for more than half the lines sold to PTI. Additionally, Staff notes that technicians from Hermiston, Baker City, or Pendleton sometimes backfilled even the directly served exchanges because of illness or vacation.

Staff also notes that USWC did not update its 1993 power cost information to 1995 for the 23 sold exchanges, and did not include any power costs for the Durkee or Merrill exchanges or power for outside remote facilities.

In his prefiled testimony, Mr. Inouye compared USWC "equivalent employee" counts in September 1995 (3,865) and December 1995 (3,891) and suggested that these figures indicate that Staff’s direct employee reduction analysis is unreliable. The 3,891 figure, Staff objects, does not include changes in the Oregon allocated headquarters and centralized employee calculations due to the PTI sale. The revised factors incorporating the sale were not computed until January 1996. Staff points out that the March 1996 headcount is the first quarterly equivalent employee number available after the PTI sale that includes the impact of the sale. That number is 3,863, or 38 fewer employees than the December 1995 figure and 196 fewer employees than the March 1996 figure. Staff argues that a proper comparison of equivalent employee numbers supports Staff's estimate of UP 96 controllable employee cost savings.

Finally, USWC contends that Staff's UP 96 adjustment errs in using the USWC financial analyses that were based on "steady state operations." Staff acknowledges that other aspects of USWC's operations may change, but asserts that its proposed adjustment fairly captures USWC's savings on a going forward basis. Staff argues that USWC's Oregon equivalent employee counts are falling. Staff also notes that USWC's employee efficiency per access line is improving (down to 31.2 employees per 10,000 access lines in third quarter 1996, compared with 32.7 in third quarter 1995). Hence, Staff contends, steady state assumptions for purposes of a UP 96 adjustment are fair and reasonable to USWC.

Disposition. Staff presents its proposed adjustment as a normalizing adjustment to remove from the test year expenses that, due to the sale of 23 exchanges, USWC no longer incurs. We find such an adjustment reasonable, and USWC does not oppose such an adjustment in theory, it appears. The conflict is about how to measure the effects of the UP 96 sale. USWC objects to Staff's methodology on the ground that USWC's expenses for network technicians, among other categories of expense, continue to grow.

We find that USWC's objection misses the point of Staff's adjustment. The growth in network technician expense, as an example, is necessarily unrelated to the UP 96 sale of exchanges. That is, exchanges that USWC no longer owns cannot possibly account for increased network technician expenses. USWC's objection that its overall expenses are increasing in various categories does nothing to address the question of how to adjust the test year to account for expenses it will not occur, due to the sale of exchanges to PTI.

We conclude that Staff's methodology for calculating controllable labor and nonlabor expense reductions due to the sale of exchanges is proper. Staff used USWC's own financial analyses to compute the costs savings. USWC's arguments in this docket attempt to minimize the costs, but we find them unpersuasive. Staff's proposed adjustment of reductions of controllable labor expenses of $1.991 million and nonlabor expenses of $1.039 million are adopted.

Issue 6, Operating Revenues. The discussion at pages 62-68 of Order No. 97-171 is readopted.

ISSUE 6: OPERATING REVENUES

Completely Settled Issues:

- *Issues 6a-b, EAS Conversion (Adjustment 27 [and Adjustment 28]).* Staff and USWC agree to include the annual effects of 13 new extended area service (EAS) routes, effective October 7, 1995, and 18 routes that will be converted on October 5, 1996. *See* First Stipulation, Paragraphs 12-13.

- *Issue 6d, Switched Access Filing (Adjustment 30).* Staff and USWC agree to (a) restate the test year to include the final revenue requirement from the annual access filing that was effective February 21, 1996, and (b) add the effects of the 1996 Oregon Customer Access Fund filing on USWC's access expense. *See* First Stipulation, Paragraph 14.

Disputed Issue:

- *Issue 6c, Tariff, Price, and Contract Changes Made after January 1, 1995 (Adjustment 29).* Staff adjusted the test year to include the effects of the many tariff and price list filings USWC made after the company filed its testimony in December 1995. USWC disagrees about the need for normalizing and pro forma adjustments. See discussion under Issue 1a(1) above. In addition, Staff annualized the effects of tariffs that USWC changed during January through September 1995. USWC disagrees with most of the filings Staff included in this adjustment.

Issue 6c deals with revenue and cost changes resulting from 26 USWC tariff, price, and contract change filings.[31] Staff proposes a net increase to local revenues of $7.92 million and a $.029 million net decrease to long distance revenues.

The filings introduce new and revised services, local service contracts, rate increases, and local service promotions. Staff argues that its adjustment recognizes the reasonably anticipated changes to revenues, expenses, and capital costs arising from the filings. Staff argues that the impact of the filings on USWC's operations during the time rates will be in effect is reasonably certain and that Staff's adjustment accurately reflects that impact.

Settled Filings: Filings 7, 8, 10 (in part), 14, 22, and 24 are completely settled.

Partially Settled Filings: Filing 2: issue of use of 1995 actual data has been removed.

Filing 18: issue of double counting of revenues has been removed.
Filings 12 and 25: issue of migration effects has been removed.
Filing 19: issue regarding elimination of two promotions has been resolved.

Areas of General Disagreement: *The Test Year Issue.* USWC objects to most of Staff's adjustments. USWC's first class of objection has to do with test year construction. USWC does not object to post test year adjustments in general, but notes that volume changes are usually not adopted because they distort the relationship among expenses, revenues, and investments. Several adjustments are annualizations of in year volume changes (sales promotions and new service introductions). USWC argues that Staff's revenue adjustments for filings 1, 2, 3, 5, 6, 9, 10, 11, 12, 13, 15, 17, 18, 19, 20, and 21 are flawed

[31] The tariff filings, their effective dates, the annual revenues (from USWC's work papers), annual expenses (also from USWC work papers), number of days to add to annualize the test year, and annualized adjustment after Staff's final revisions are attached as Appendix D and incorporated herein by reference.

because there is no accounting for the related expenses and capital costs.

Staff responds that it twice revised its testimony in express recognition of the original testimony's omission of some volume related filing expenses and capital costs. Its revisions were based on additional information and corrections offered by USWC. Staff argues that its amended testimony corrects for the interdependency problem raised by USWC. Staff maintains that its final position properly recognizes the relationship among revenues, operating expenses, and capital costs associated with the filings.

Disposition. In our discussion at Issue 1a(1), we approved Staff's post test year adjustments as reasonable. We do so again here. Staff's adjustments serve to make the test year representative of the time when rates from this docket will be in effect. Staff has made considerable effort to revise its adjustments to reflect volume related filing expenses and capital costs. The record shows that after conferring with the company, Staff witness Mr. Ball twice revised his adjustments in the company's favor. We conclude that Staff's adjustments to the filings do not distort the test year as USWC alleges.

Forecasted v. Actual Data. USWC's second objection has to do with the fact that Staff relied on forecasted information when actual results were available, although Staff admitted that actual results were available. USWC notes that the test year already contains actual revenue for the period the price change was in effect. Therefore, USWC argues, Staff's test year has a combination of actual and forecasted revenue. USWC contends that the Commission should not rely on a forecast when actual information is available.

Staff responds that it properly chose to use company supplied incremental costs (LRIC, or long run incremental costs) as a surrogate for operating expenses and capital costs for each filing. Staff also used USWC information, provided with the filings, for its estimate of revenues. Staff points out that USWC's actual data was unverified and presented late in the rate case. Therefore, Staff used the incremental costs.

Disposition. USWC relies on a court case and a number of cases from other commissions for the proposition that the Commission should not use a forecast when actual information is available.[32] These cases do not resolve our issue. The issue here is not whether actual data are preferable to forecasted data. That may well be the case, as a general rule. The issue is rather what it means to say data are available. If USWC produces data for Staff's consideration so late in the day that Staff has inadequate opportunity to verify and possibly normalize the data, they are not available for all practical purposes. Here, we find that USWC produced its actual data too late for verification. The actual data on these issues were, therefore, not available to Staff.

We find the use of LRIC as a surrogate for operating expenses and capital costs reasonable. Staff acted correctly in using the best information available to it. Moreover, Staff's witness Mr. Ball used company provided actual historical data along with company provided estimates as the basis for his adjustment.

Areas of Specific Disagreement: *Costs for Filings 2 and 3*. USWC contends that Staff did not include costs for filings 2 and 3. Staff replies that USWC failed to include any costs in the work papers it submitted in support of those filings. Staff contends that its approach is therefore consistent with USWC's filings.

Disposition. We conclude that USWC did not supply cost data with its work papers. Therefore, USWC may not now complain that Staff did not include costs for those filings. The company has not met

[32] *State Public Service Commission v. Mississippi Power Company*, 429 So2d 883 (Miss.), *cert. denied*, 464 U.S. 819 (1983); *In re Missouri Public Service*, 152 PUR 4th 333 (1994); *In re Jamaica Water Supply Co.*, 104 PUR 4th 273 (1989); and *In re Boston Edison Co.*, 53 PUR 4th 349 (1983).

its burden of producing cost data to show that its costs are reasonable.

Overlap with Issue 8j. Additionally, USWC asserts that this adjustment overlaps with Staff witness Ed Morrison's Issue 8j adjustment for average growth in access lines. USWC charges that Staff witnesses were aware of the possibility of overlap and distortion, but failed to coordinate regarding Issues 6c and 8j. The company argues that this lack of coordination results in an unreasonable overall final result for Staff's case. See discussion at Issue 1a(1) above.

Staff responds that Mr. Ball's predecessor as witness on this issue, Jon Wolf, was part of a group that included Mr. Morrison and which met to discuss the various Staff adjustments under consideration at the earliest stages of the case.

According to Staff, after Mr. Wolf left the Commission, Mr. Ball took over his duties on this case. Mr. Ball considered USWC's claim of overlap with Mr. Morrison's adjustment and was satisfied that there was no overlap. Mr. Morrison's adjustment was based strictly on access line growth. Mr. Ball's adjustment restates 1995 booked revenues, operating expenses, and capital costs to appropriate test year levels and then identifies 1996 annual revenues, operating expense, and capital costs associated with the 26 tariff filings on a prospective basis. Staff also points out that USWC does not explain how these adjustments overlap.

Disposition. As Staff has explained, Mr. Morrison's and Mr. Ball's adjustments address very different issues. USWC has not explained how these issues overlap. We are persuaded that they do not overlap.

Additional Argument; Disposition. Finally, we note that USWC summarily argues that Staff's adjustment annualizes some in year events, such as promotions and new service offerings, while ignoring others. USWC concludes that the adjustment is unbalanced and should be rejected. This argument is not developed and we cannot determine its reference. The argument is rejected.

Filings with No Settled Issues: Filings 1, 3, 4, 5, 6, 9, 10 (in part), 11, 13, 15, 16, 17, 20, 21, 23, and 26 are completely unsettled.

Promotional Filings. Filings 1, 5, 6, 11, 12, 15, 17, 19, 20, and 21 concern promotional filings. USWC argues that promotions are short lived and that their effects should therefore not be recognized in this rate case. USWC argues that Staff adjusts the test year as if the demand were present throughout the year, whereas, according to USWC, Staff admits that promotions do not cause a permanent change in demand units. Promotions, USWC contends, have service lives of 12 to 25.4 months. USWC points out that Staff witness Lance Ball testified that promotional activity would be relatively short lived.

Moreover, USWC argues that Staff has previously taken the position that promotions have a specific time frame. USWC refers to a Staff memo dated April 23, 1992 to support its position that changes due to promotions are temporary and should not be annualized.[33]

According to Staff, its review shows that the promotions at issue represent an express company action calculated to permanently change customer demand for service. Confidential Staff Exhibits 91 and 92 show that USWC expects certain promotion units to remain in service for 12 to 25.4 months. Certain promotions are designed to have a longer term effect, as Mr. Ball testified:

> In some revenue studies filed by U S WEST to support its tariff filings, the company forecasts revenues several years out. By doing so, the company is apparently trying to justify promotions that are heavily discounted in the near term (with the consequence of less near term revenues) with higher revenue streams in the longer term. Supplemental Staff/32, Ball 3-4.

[33] According to the memo, Appendix B to USWC’s reply brief, “Promotions should be limited to 120 days per year for each service.”

Disposition. USWC is correct that Appendix B to its brief sets a time frame of 120 days for promotions. Thus it is accurate to say that promotions are short lived. However, USWC conflates the duration of promotions themselves with the impact of promotions. The record shows that the desired impact of promotions, which USWC projects in its promotional tariff filings, is to increase demand for the promoted service for a longer period than the period of promotion. USWC projects the effects of promotions mentioned in the record from one to several years. We conclude that Staff is correct in assuming a long term effect for promotions and that Staff's adjustment captures the reasonable financial effects of the promotions during the period rates will be in effect.

Filings 25, 26. USWC asserts that Staff failed to include the economic effects of migration between services that the filings cause. That is, if a filing results in a customer using a new service rather than an existing service, the effects of the filing for the new service may be overstated.

Staff responds that USWC failed to include any effects for alleged migration in the work papers it filed in support of filing 26. Where USWC work papers identified cross elastic or migration effects for other services, Staff asserts that it did incorporate all such effects as estimated by the company. Staff points out that USWC witness Inouye testified that Staff incorporated migration effects for filings 12 and 25.

Disposition. We are persuaded by Staff's arguments on the migration effects of the filings. Where USWC failed to provide information on projected effects of migration, Staff properly worked with the information available to it. Staff could not account for an effect USWC did not identify. Where USWC provided information on migration or cross elastic effects, Staff incorporated them. We conclude that Staff's treatment of migration or cross elastic effects for the filings was correct.

Filing 16: Frame Relay Special Contract Issues. Frame Relay is a five year special contract that took effect in 1996. This filing accounts for most of the dollar differences between Staff and USWC. Staff alleges that the difference is due to several mistakes USWC made in calculating the costs, revenues, and rate base associated with this filing. .

Staff argues that USWC has front loaded all of the five year contract costs during the test year, so that the company shows a net revenue loss of $7,233,482 for this contract during the test year.[34] Staff argues that it is improper to account for all costs in the beginning of a contract, as USWC has done with filing 16. The company shows employee related costs of $6.5 million for the first year of the contract,[35] but at the April 2, 1996, Public Meeting, USWC informed the Commission that it was dedicating only 16 fulltime network technicians to the Frame Relay project.[36] Staff argues that USWC could not be expending $6.56 million for 16 employees the first year of the contract and concludes that the contract expenses must have been improperly front loaded.

Staff also asserts that USWC incorrectly used a higher budgeted estimate of expense as a basis for its adjustment in USWC Exhibit 72. That exhibit shows an expense of $7,625,782 (the sum of columns 7 and 8 on line 16). Staff Exhibit 96 shows that figure to be the total sum requested for 1996 for the Frame Relay project. USWC argues that although the figure appears in the column headed "requested," and the figure in the column headed "funded" is much lower, the $7.6 million represents actual expenditures. That figure includes the $6.56 million employee related costs.

Finally, Staff contends that USWC miscalculated the amount for "average total plant in service" (ATPIS) on USWC Exhibit 72. The methodology to calculate ATPIS is to calculate a monthly average for the TPIS and then average the months to

[34] This figure is from USWC Exhibit 72, line 16, col. 10.
[35] See Confidential Staff Exhibit 96 at 8, lines 13-14.
[36] We take official notice of the minutes of the April 2, 1996, Public Meeting, pursuant to OAR 860-014-0050.

determine the annual average. Staff argues that a comparison with confidential Staff Exhibit 96 reveals that this amount has not been averaged, but rather represents the entire funded amount. Staff contends that the average amount should be about one half the amount USWC uses. The effect, according to Staff, is to overstate the average rate base adjustment by almost $4 million.

Staff argues that Mr. Ball’s approach avoids the errors that USWC commits. Mr. Ball shows a slight positive net adjustment to revenues of $159,084 for filing 16. Staff’s conclusion, it argues, is consistent with the position it took at the April 2, 1996, public meeting and is consistent with the comments by the company’s representative at that same meeting. Rather than front loading expenses, as USWC did, Staff contends that it normalized total revenues, expenses, and capital costs over the five year life of the contract. Therefore, Staff believes its estimates represent the average revenue, average cost, and average margin over the life of the agreement.

Disposition. We find that for filing 16, USWC has not shown that its costs are reasonable and has not reconciled its statement at the April 2, 1996, public meeting about the number of employees involved in the Frame Relay contract with the $6.56 million figure on confidential Staff Exhibit 96. On the record before us we cannot find that the $6.5 million are reasonable costs. We also find its calculation of ATPIS flawed, as Staff has argued. We conclude that USWC has front loaded its contract expenses into the first year of the contract. As Staff argues, it would be inappropriate to include more than annualized expenses for the contract in the test year. Staff’s adjustment, on the other hand, is reasonable and should be accepted.

Conclusion. Staff’s adjustments to the 26 filings involved in Issue 6c are reasonable and are adopted.

Issue 7, Employee Benefits. The discussion at pages 68-72 of Order No. 97-171 is readopted.

ISSUE 7: EMPLOYEE BENEFITS

Completely Settled Issues:

- *Issue 7b, AT&T Unfunded Postretirement Benefits Cost Sharing (Adjustment 33).* Staff and USWC agree to restate expenses to include annual reimbursements from AT&T, which were recorded in December 1995. *See* Appendix B, First Stipulation, Paragraph 15.

- *Issue 7c, Disability Pension Payment Trueup (Adjustment 34).* Staff agrees with USWC's proposal to remove a duplicate accrual. *See* Appendix B, First Stipulation, Paragraph 16.

- *Issue 7d, Pension Accounting (Adjustment 35).* Staff and USWC agree to leave the negative pension costs in operating expense, leave the related accumulated deferred taxes in the rate base, and add the pension asset to the rate base. *See* Appendix C, Second Stipulation, Paragraph 4.

- *Issue 7e, End of Compensated Absences Accrual (Adjustment 36).* Staff and USWC agree to normalize expenses to reflect an accrual that will end in December 1997. *See* Appendix C, Second Stipulation, Paragraph 5.

Disputed Issues:

- *Issue 7a(1), Statement of Financial Accounting Standards (SFAS) 106 Postretirement Benefits (Adjustment 32).* Staff opposes USWC's proposal to add a nonrecurring December 1995 accrual for a curtailment loss associated with restructuring and recommends continued amortization. The final amount depends on whose adjustment the Commission adopts. *See* Issue 1a(1), Test Year. *See also* Appendix C, Second Stipulation, Paragraph 4.

- *Issue 7a(2), Statement of Financial Accounting Standards (SFAS) 106 Postretirement Benefits (Adjustment 32a).* Staff and USWC agree that the rate base should reflect unfunded postretirement benefits but disagree about the amount. The final amount depends on whose adjustment the Commission adopts. *See* Issue 1a(1), Test Year.

Issue 7a(1): SFAS 106 Postretirement Benefits
USWC and Staff have agreed on the amounts for this adjustment but not on how the amounts should be treated for ratemaking purposes.

In the past, USWC, like most companies, recognized the costs of providing postretirement benefits when they actually made the payments. This pay as you go approach was considered to meet generally accepted accounting principles when health care costs were not considered material. As health care costs increased, the Financial Accounting Standards Board (FASB) reconsidered how to account for postretirement benefits, benefits other than pensions (PBOPs), and other postemployment benefits. FASB concluded that companies should begin to accrue retiree postemployment benefits just as they accrue pensions. In December 1990, FASB issued SFAS 106, "Employers' Accounting for Postretirement Benefits other than Pensions."

SFAS 106 required USWC to recognize the accumulated obligation for PBOPs not recorded during prior periods. SFAS 106 permitted this obligation, called the Transition Benefit Obligation (TBO), to be amortized over 20 years or less. For regulatory monitoring reports, USWC has been amortizing the TBO over 17.3 years (from January 1, 1992 through March 31, 2009). For financial reporting, USWC made a one time writeoff of part of the TBO in 1992. USWC’s 1995 results of operations include PBOPs expenses, both current period and the TBO amortization.

USWC’s reengineering program caused the termination of around 9,000 employees who had been included in calculating the TBO’s 17.3 year amortization. SFAS 106 requires USWC to recognize the remaining TBO of these employees as a one time curtailment loss. That is, USWC is to expense the curtailment loss when it becomes known. In December 1995, USWC recorded the curtailment loss for regulatory accounting purposes, in compliance with SFAS 106. As a result of expensing the curtailment loss due to reengineering program terminations, the remaining amount of the TBO to be amortized is reduced. Staff estimates that the 1995 curtailment loss will reduce the recurring TBO amortization by $.586 million per year.

Staff considered three options for the ratemaking treatment of the curtailment expense:

1. Treat the curtailment loss as a recurring expense (USWC’s proposal);

2. Amortize the curtailment loss over the remaining life of the TBO (Staff’s proposal); or

3. Remove all the effects of the curtailment loss from the test year.

Option 1—Treat the curtailment loss as a recurring expense. USWC argues that the curtailment expense is one of several expenses that will recur during the period Staff expects rates to be in effect, but not over the entire period. Others such expenses are compensated absences (Issue 7e), PUC fee (Issue 8n), and the

Western Electric side record (Issue 1c(2)(a)). For those costs, USWC argues that Staff sums the expenses that will occur and spreads them over the entire period when rates will be in effect.

For the current issue, USWC alleges that Staff proposes to disallow the entire amount. USWC asserts that it is unreasonable to assume, as Staff does, that reengineering and curtailment expenses were never incurred. USWC also asserts that it is arbitrary to treat the curtailment expense differently from the other expenses listed above. USWC recommends that the curtailment expenses be spread over the period of rates, just as Staff has done with the above costs.

USWC argues that it will record curtailment expenses in 1996 and 1997. The company is on record with the Securities and Exchange Commission (SEC) that the reengineering program, to which curtailment expenses are related, will continue through 1997. USWC informed the SEC that a $210 million total curtailment expense will be recognized. The FCC required USWC to record the $210 million as a below the line expense in account 7360 and to bring that amount above the line as employees leave the company before the end of 1997. As of the end of 1995, $140.4 million of the $210 million had been recognized. The remaining amount will be recognized in 1996 and 1997. Applying Staff's method to this remaining amount, USWC believes that the test year adjustment should be an increase in expense of $1.7 million.

USWC argues that the TBO must also be restated in Staff's adjustment. According to USWC, if Staff restates the test year as if reengineering never happened, then the 1994 curtailment expense also never happened. Reengineering is a multi year program that began before the 1995 test year. In turning back the clock to the time before this program, the 1994 TBO amortization should be reflected in the test year. The 1994 TBO is $.4 million higher than the 1995 TBO. This amount, USWC contends, should be added to the test year if the Commission adopts Staff's recommendation.

USWC proposes that for the purpose of determining a refund and assuming the Commission uses 1995 financial data, the full amount of 1995 curtailment expenses, about $5.6 million, should be added to the test year. Otherwise, USWC would be required to refund earnings it did not achieve. For the purpose of setting going forward rates, the spreading over the period for rates should be adjusted accordingly. In the alternative, USWC proposes to use 1996 and 1997 actual levels for the test year expense.

Staff points out that USWC has not adjusted the test year payroll costs for the curtailed employees. If USWC does plan to cut an additional 9,000 employees during 1996-1998, the test year should be adjusted to reduce the amortization of the TBO and to reduce payroll costs.

Staff argues that curtailment losses of this magnitude--involving 9,000 employees--are unlikely to recur each year during 1996, 1997, and 1998, when rates from this docket will be in effect. Probably reengineering will take place through most of 1996 and into 1997 (*see* Issue 9a below). The curtailment cost will not recur in all the months when rates from this docket will be in effect. Therefore, Staff argues, it would be inappropriate to include the curtailment loss in the test year.

Option 2—Amortize the curtailment loss. Staff’s recommendation is to amortize the curtailment loss over the remaining 13.3 years of the TBO for ratemaking purposes. This has no revenue requirement effect. Rates from this docket would be set to allow USWC to recover the curtailment loss through continued amortization.

Staff points out that if USWC experiences additional curtailment losses of any size in the future, this option would leave the TBO amortization expense unaffected and would normalize expenses. Staff argues that this treatment of the curtailment loss is consistent with its treatment of the compensated absences, Western Electric Side Record, and PUC fee issues. That is, Staff spread those expenses over the period rates from this docket will likely be in effect. Here, Staff spreads the loss over the remaining life of the TBO.

Option 3—Remove the curtailment loss. Under Option 3, the curtailment loss would be treated as a one time nonrecurring expense to be removed from the test year. The 1995 curtailment loss will reduce the TBO recurring amortization expense for total regulated Oregon operations subject to separations by $.6 million beginning in 1996. Option 3 would reflect this recurring expense level and reduce total Oregon operation expenses in the test year by $.6 million.

Disposition. USWC proposes to include the curtailment expense related to termination of approximately 9,000 employees in the test year. Staff proposes to amortize the curtailment expense. We find USWC's proposal unfair to ratepayers and Option 3 unfair to USWC. We elect Staff's option of amortizing the remaining expense. This option recognizes the expense and allows USWC to recover it without revenue requirement consequences.

Issue 7a(2): Unfunded SFAS 106 Postretirement Benefits

In this adjustment, Staff proposes to reduce rate base for unfunded postretirement benefits. Staff notes that the Commission has determined to treat accumulated unfunded balances in postretirement benefits obligation accounts as rate base credits. *See* Order No. 91-186 (UE 79) and Order No. 91-1786 (UT 101).

USWC proposed a rate base adjustment for SFAS 106-to use the average 1995 unfunded balance. Staff adjusted USWC's rate base to reflect an average level during the period to be covered by the new rates from this docket. Staff calculated the average balance during the period rates are likely to be in effect. With expense and funding levels staying constant indefinitely, the unfunded total regulated Oregon operations subject to separations rate base reduction will continue to grow by $418,600 per year indefinitely.

USWC responds that the issue is whether the Commission should reduce the rate base by a forecast of the September unfunded benefits. This issue relates to test year construction. If the Commission does not adopt Staff's forecasted adjustments that restate the test year to August 1997, it should also reject this adjustment.

Disposition. We have decided in principle to accept Staff's forecasted adjustments that restate the test year to August 1997. We find this proposed adjustment consistent with those adjustments and conclude that it should be accepted.

Issue 8, Operating Expenses and Taxes. The discussion at pages 72-83 of Order No. 97-171 is readopted except as modified with respect to Issue 8f and Issue 8n.

Issue 8f, ORS 291.349 Income Tax Refund: In the companion order to the current order, Order No. 00-190, Staff modified adjustments at Issues 3 and 9 that affected taxable income. The Issue 8f discussion at pages 72-73 of Order No. 97-171 is here readopted, but the amounts in Column 42 of Appendix A to Order No. 97-171 are amended as shown in Appendix B to Order No. 00-190, Column 42.

Issue 8n, PUC Fee Increase: The discussion at page 83 of Order No. 97-171 is readopted, but the amounts in Appendix A, Column 49a, are amended as shown in Appendix B to Order No. 00-190, Column 50.

ISSUE 8: EXPENSES AND TAXES

Completely Settled Issues:

- *Issue 8b(1), 1996 Occupational Wage Increases (Adjustment 38)*. Staff and USWC agree to include 1996 occupational wage increases. *See* Appendix B, First Stipulation, Paragraph 17.

- *Issue 8b(2), Other Payroll Changes (Adjustment 38c).* Staff and USWC agree to include 1996 payroll tax changes. *See* Appendix C, Second Stipulation, Paragraph 7.

- *Issues 8c-d, Changes in Accounting—SFAS 109 and 112 (Adjustments 39-40).*

Staff supports USWC's requests to adopt SFAS 109 and SFAS 112. SFAS 109 required changes in accounting for income taxes by 1993. SFAS 112 required changes in accounting for the employer's obligation to provide postemployment benefits for former or inactive employees, their beneficiaries, and their covered dependents by 1994. *See* Appendix B, First Stipulation, Paragraphs 18-19.

- *Issue 8e, Ballot Measure 5 Property Tax Savings (Adjustment 41).* Staff and USWC agree to restate property tax expenses to reflect a full year at the final year's tax rates (1995/96). If the Commission orders a refund based on the revenue requirement established in this docket, Staff recommends that USWC's Measure 5 savings refund for May and June 1996 be used to reduce the amount of the UT 125 refund. *See* Appendix B, First Stipulation, Paragraph 20.

- *Issue 8g, Docket UM 767 Oregon Depreciation Represcription (Adjustment 43).* Order No. 96-117 approved new depreciation rates retroactive to January 1, 1995. Staff and USWC agree to restate the test year to include one year's effect of the revised depreciation rates on expenses and average rate base. *See* Appendix B, First Stipulation, Paragraph 21.

- *Issues 8h-i, Aircraft and Advertising (Adjustments 44-45).* Staff and USWC agree that aircraft and advertising expenses in the test year are reasonable and should not be adjusted. *See* First Stipulation, Paragraphs 22-23.

- *Issue 8m, Purchase Rebates (Adjustment 49).* Staff and USWC agree to restate the test year to remove the effects of prior period rebates. *See* Appendix B, First Stipulation, Paragraph 24.

Significantly Undisputed Issue:

- *Issue 8f, Oregon Revised Statute (ORS) 291.349 Income Tax Refund (Adjustment 42).* Staff and USWC agree to normalize the test year to reflect periodic state income tax refunds received by USWC under ORS 291.349. The final amount depends on the resolution of disputed issues. *See* Appendix C, Second Stipulation, Paragraph 8.

Disputed Issues:

- *Issue 8a, Team Performance Awards and Officers' Incentives (Adjustment 37).* In compliance with Commission policy, Staff removed bonuses based on corporate cash flow and earnings.

USWC disagrees with Staff's adjustment. USWC contends that Staff has the burden to prove its proposed disallowance is justified and reasonable. Staff believes that the company has the burden to show that its costs are reasonable.

- *Issue 8b(2), Other Payroll Changes (Adjustments 38a, 38e, and 38f).*

    - *Adjustment 38a.* Staff added 1996 management salary increases and 1997 occupational wage and management salary increases. USWC agrees with the mechanics of Staff's adjustment but disagrees about the need for pro forma adjustments. The final amount depends on whose adjustment the Commission adopts as well as the resolution of Issue 4f, Headquarters Allocations.

    - *Adjustments 38e-38f.* Staff modified the wage and salary bases to remove the nonrecurring wages related to reengineering. USWC agrees with the mechanics of Staff's adjustments but disagrees about the need for the adjustments. *See* Issue 8a and Issue 9a, Reengineering. The final amounts depend on whose adjustments the Commission adopts and the resolution of Issue 4f, Headquarters Allocations.

- *Issue 8j, Average Growth in Access Lines (Adjustment 46).* Staff adjusted the test year to recognize that local revenues per access line have been relatively constant and that access lines are growing. Staff increased local revenues by 3 percent to reflect the average level during the period when rates from this docket will be in effect. USWC disagrees about the need for pro forma adjustments. If the Commission includes Staff's adjustment in the test year, the final amount depends on the resolution of Issue 6c, Tariff, Price, and Contract Changes Made after January 1, 1995.

- *Issue 8k, Marketing Accrual Reversal (Adjustment 47).* In its preannualization adjustments, USWC identified a reversal entry that is part of a series of accrual entries and actual claims paid for carrier accidents and damages.

- *Issue 8l, Information Management Systems (Adjustment 48).* Staff normalized costs by including the ongoing expense savings for two recently implemented information management projects (SAVER and bill reformatting). USWC disagrees about the need for normalizing adjustments.

- *Issue 8n, PUC Fee (Adjustment 49a).*[*] Staff expects the PUC fee to increase from .20 percent to .25 percent for assessments due on and after April 1, 1997. USWC disagrees about the need for pro forma adjustments. USWC also disagrees that the change is probable.

Issue 8a: Incentive Plans (Bonuses)

USWC proposes to include in the test year $4 million in bonuses that were paid to its management and executive employees in 1995 under three incentives programs: (1) Team Performance Award Plan (TPA); (2) Executive Short Term Incentive Plan (STIP), and (3) Executive Long Term Incentive Plan (LTIP).

Bonuses paid under these plans were based on the achievement of certain financial, business, and corporate goals. The 1995 TPA bonuses were paid

[*] Issue 8n is now Adjustment 50 of Appendix B to Order No. 00-190.

for meeting or exceeding goals regarding (1) Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA); (2) USWC Net Income; and (3) Business Unit Results & Strategic Measures, and Customer Service. The 1995 STIP bonuses were paid for meeting or exceeding goals regarding (1) Financial Performance (new product development, net income, EBIDTA); (2) Reengineering Benefits; and (3) Customer Loyalty. The 1995 LTIP bonuses were paid for meeting or exceeding goals regarding (1) increase in the price of USWC stock; and (2) stock dividend growth.

Staff takes the position that these bonuses should be excluded from the test year because the financial, business, and corporate goals on which the bonuses were based primarily benefited USWC’s shareholders. Therefore, Staff reasons, the shareholders should pay for the bonuses.

Staff notes that in the past, the Commission has not allowed a utility’s revenue requirement to include employee bonuses that were based on the utility’s financial results of operations. ***See, e.g., Pacific Northwest Bell Telephone Company***, UT 43, Order No. 87-406 at 42, where we stated:

> Only expenditures necessary for furnishing utility service should be reflected in rates. ***Portland General Electric***, UF 3218, Order No. 76-601 at 13; ***Cascade Natural Gas***, UF 3246, Order No. 77-125 at 10.

Staff contends that USWC’s base salaries for management and executive employees are reasonable, but maintains that USWC has not shown that the goals on which the bonuses were based were justified by benefits to ratepayers. For instance, Staff notes that although quality of service deteriorated in 1995, the total TPA did not decline.

Staff concludes that the performance goals under USWC’s management incentive plans were designed to benefit shareholders but were not in the ratepayers’ interests. Staff argues that it is inappropriate for USWC’s Oregon ratepayers to pay for bonuses for the utility’s management and executive employees at a time when USWC's service quality problems in Oregon have increased significantly and when, as Staff believes, USWC is overearning by $100 million. Including the bonuses in the revenue requirement in this situation, Staff argues, would add insult to injury for ratepayers.

Finally Staff notes that although it recommends excluding USWC's executive and management bonuses from the test year in this case, in future rate cases it would consider including employee incentive plans with goals that would benefit both ratepayers and shareholders.

USWC argues that its overall level of compensation, including bonuses, is not only reasonable but is below market. USWC argues that Staff is asking the Commission to preclude recovery of expenses that the record shows were actually incurred by the company, and that are reasonable. USWC also argues that excluding bonuses would amount to micromanaging the company.[37] That is, the Commission would be deciding what form compensation of company management should take.

USWC further argues that paying market wage levels including incentive compensation is necessary for the provision of utility service. If bonuses were eliminated, USWC points out, salaries would have to be raised an equal amount to attract employees. Therefore, USWC argues, Staff's proposed disallowance is arbitrary, because it is based only on the manner in which compensation is administered.

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[37] USWC argues that most commissions follow the principle that "managers of a utility have broad discretion in conducting their business affairs and in incurring costs necessary to provide services to their customers," including compensation decisions. *Violet v. FERC,* 800 F2d 280, 282 (1st Cir. 1986). USWC also cites two California cases that advocate leaving the allocation of compensation between salaries and incentives to the utility's discretion. *In re Pacific Gas and Electric Co.*, 1992 WL 438101 slip op at 46 (Cal. PUC); *In re Southern California Edison Co.*, 130 PUR 4th 97, 126 (1991) ("The Commission's duty is to authorize reasonable expenses for employee compensation as a whole, without micromanaging the distribution of employee salaries, wages, and benefits.").

USWC maintains that Staff has never previously challenged manager bonuses, and asserts that the facts in UT 43, the case on which Staff relies, are distinguishable from those in this case. USWC contends that use of incentive pay is common in the industry and encourages enhanced USWC employee performance toward ratepayers. If Staff’s proposal is adopted, USWC maintains, it will send a signal to the company that it should not try to provide financial incentives for employee performance.

Finally, USWC argues that the Commission should allow recovery of bonuses to prevent discriminatory treatment of USWC in a competitive environment. USWC notes that its major competitors rely on incentive pay to compensate their employees. According to USWC, this indicates both that the practice of offering incentive pay is widespread and that the Commission should allow USWC’s bonuses because to do so would be competitively neutral.

Disposition. The record shows that USWC’s base salaries before bonuses are within a reasonable range, as is USWC’s compensation including bonuses. Because its compensation is reasonable compared to the market, USWC concludes that its expense for management and executive bonuses is reasonable. USWC conflates two separate issues. The level of overall compensation is reasonable compared to the market. That does not determine whether it is reasonable to ask ratepayers to fund bonuses with the declared goals of USWC’s incentive plans.

USWC is correct in stating that Order No. 87-406 (UT 43) does not preclude recovery of incentive pay linked to financial performance. The disallowance in that case occurred because the proposed compensation was based on the performance of the utility’s parent, not the utility itself. Still, the principle that Staff quotes from that order is our policy: “Only expenditures necessary for furnishing utility service should be reflected in rates.” Order No. 87-406 at 42.

We disagree that submitting USWC compensation expenditures to scrutiny is micromanaging; rather, it is our role as regulators to determine the reasonableness of USWC's claimed expenses. On review of the stated goals for the incentive programs at issue, we note that some of the goals on which bonuses were awarded deal with earnings, net income, financial performance, reengineering benefits, and stock prices and dividend growth. These goals benefit shareholders rather than ratepayers.

Two of the goals deal with customer service and customer loyalty. In view of the problems USWC has had with customer service (see discussion at Issue 9c below), we agree with Staff that it is inappropriate to award bonuses for performance in this area.[38] We point out that here our decision deals with bonuses for management and supervisory personnel. We do not mean our comments to reflect negatively on front line employees, who have done well under a difficult set of circumstances.

Under the circumstances of this case, we conclude that USWC has not shown that its incentive plans are reasonable expenses for the provision of utility service. We note that our disallowance is not based on the manner in which compensation is administered but on the purpose for which the bonuses are awarded. We also note that this conclusion does not prevent USWC from paying bonuses; it merely dictates that bonuses be paid from funds that would go to shareholders, not from funds provided by ratepayers. Therefore, we do not believe that the resolution of this issue places USWC at a competitive disadvantage.

We limit the findings on this issue to the facts before us. If in a future rate case USWC submits employee incentive plans with goals that would benefit both ratepayers and shareholders, we will include those expenditures in revenue requirement.

Issue 8b(2): Other Payroll Changes

[38] USWC appears to argue that Staff raises the argument of disallowance based on service quality issues for the first time in its brief. This is incorrect. *See* Revised Staff/1 Lambeth/65.

In this adjustment, Staff proposes to add the effects of wage rate changes for 1996 and 1997 to the 1995 test year. USWC agrees with the mechanics of Staff's adjustment but disagrees about the need for pro forma adjustments. *See* discussion at Issue 1a(1) above. The final amount of this adjustment depends on whose adjustment the Commission adopts as well as the resolution of Issue 4f, Headquarters Allocations.

USWC implies that Staff's adjustment treats reengineering as if it had not happened, while including the effects of wage rate changes. Staff responds that its adjustment is to eliminate from wage and salary bases nonrecurring wages related to reengineering. It has calculated its pay increases on a wage base that excludes wages related to reengineering and extraordinary expense. Terminated jobs will not be replaced. Therefore, wage adjustments should not be computed for nonexistent employees.

We have determined that pro forma adjustments are appropriate to cause the test year to represent the period for which rates from this docket will be in effect. We are persuaded by Staff's argument that its adjustment makes the test year more representative of that period than it would be without the adjustment. Therefore, we accept Staff's adjustment for the effects of wage rate changes for 1996 and 1997.

Issue 8e(2): Ballot Measure 5 Property Tax Savings

This issue is addressed by the First Stipulation, Paragraph 20. Staff and USWC agree that if we order a refund in this docket, the refund should be reduced by the Measure 5 refund for May and June 1996. We adopt this recommendation.

Issue 8j: Average Growth in Access Lines

At issue here is a pro forma adjustment (see discussion of Staff's proposed adjustments at Issue 1a(1) above). As we stated previously, the purpose of a test year is to represent the period in which rates will be in effect. Therefore, to avoid overearning or underearning by USWC during that period, we add to the revenue requirement recurring increases in revenues and expenses that are reasonably certain to occur, and exclude nonrecurring revenues and expenses. *Pacific Northwest Bell Telephone. Co.,* UT 43, Order No. 87-406 at 11.

Staff proposes to adjust the test year to recognize USWC's continued access line growth and the associated growth in revenues. Staff has increased USWC's revenues by 3% per year to reflect growth in access lines.

USWC's Position. USWC argues that Staff's adjustment is for growth in revenue per access line. USWC contends that Staff has not carried the burden of showing that this adjustment is "known and measurable." USWC argues that Staff's sole evidence of an increasing trend in Oregon intrastate local revenue per line is a graph of monthly revenues per line for the period January 1994 to September 1995 (Staff Exhibit 36, Morrison 3). The graph for that short period showed a slightly increasing slope. USWC contends that the data are deceptive, because Staff witness Ed Morrison selected a small time period, excluding later as well as earlier data that refute his hypothesis. USWC charges that Staff had earlier and later data on revenue per access line, which it ignored and which would break Staff's upward trend in per line revenue growth. USWC's position is that 1995 local revenue per line is approximately the same as it was in 1992. USWC concludes that per line revenues are, at best, flat.

USWC maintains that its evidence also shows that local revenue per line would be declining significantly without USWC's new promotions and services. USWC also notes that over the next several years there will likely be downward pressure on revenue per line, given resale. The Telecommunications Act of 1996 and the Commission's certification of local service providers are causing great changes in the telecommunications industry, according to USWC, making USWC's revenue highly uncertain. USWC charges that Staff considered none of these factors in developing its revenue forecast adjustment.

USWC also argues against Staff's claim that expense per line is declining. USWC contends that Staff's sole evidence of decreasing expense per line is Mr. Morrison's graph (Staff 36, Morrison 3). This chart, USWC points out, is based on normalized data. If one includes depreciation, access expense paid to independent telephone companies, and property taxes, it is clear that expenses per line are not decreasing. USWC asserts that Staff achieves its declining expense trend by normalizing depreciation expense without justification, continuing access expense reductions and Ballot Measure 5 property tax reductions, which have been fully reflected in the test year and which have ended. USWC argues that intrastate expense has, in fact, been increasingly slightly on a per line basis.

USWC also argues that Staff could not describe any steps to ensure that it balanced expenses and revenues associated with its proposed adjustment. Staff also made no effort to show that the cumulative effect of its adjustments is reasonable and does not distort the test year. USWC asserts that it provided positive evidence that Staff's proposed adjustments overlap and create test year distortion.

Since revenue per line is flat, USWC contends, Staff's proposed adjustment 8j to increase local revenue per line overlaps with Issue 6c. According to USWC, given Staff's failure to prove that expense per line is declining, Staff's adjustments in Issues 8l, 9a and 9b, and 5a create a distorted test year by causing test year expense per line to decline significantly below the historic trend.

USWC cites the overall result of Staff's proposed adjustment to underscore how unreasonable Staff's proposed adjustment is. According to USWC, Staff forecasts that between 1995 and 1997, USWC's revenues will grow by $37.7 million while expenses will decline by $30.5 million. This results in a net revenue gain of $68.2 million, a profit margin of 18.4%, or a 50% improvement over 1995. According to USWC, Staff also projects that during the same period, access lines will increase by approximately 74,000 lines and that increase will come at a negative incremental cost.

Finally, USWC argues that Staff fails to include a comparable adjustment for forecasted changes in toll and access revenues, where revenue per line has been declining. For the two year period from 1993 to 1995, USWC contends, toll and access revenue declined by approximately $15 per line. If the Commission were to adopt forecasted local revenue growth, it should also adopt an offsetting adjustment for forecasted decreases in toll and access revenues. An expense adjustment related to access line growth would also be warranted, as would an adjustment for the effects of competitive entry.

Staff's Position. Staff responds that USWC has mischaracterized the nature of Staff's adjustment. The adjustment is for ***average growth in access lines***, not ***revenue growth per line***. Staff notes that this misunderstanding explains why USWC asserts that Staff's revenue adjustments in Issues 8j and 6c overlap. Staff's revenue adjustment in Issue 8j is based on the quantity of USWC access lines. The adjustment in Issue 6c is based on revenue; that is, it reflects changes in USWC's tariffs, prices, and contracts. Staff asserts that these adjustments do not double count revenues. Mr. Morrison testified that he did not make an adjustment for the growth in revenues per line, because revenues associated with new filings were covered by Mr. Ball in Issue 6c.

Staff's revenue adjustment to the annualized test year consists of approximately $24 million. The adjustment recognizes USWC's continued access line growth and the associated revenues. Staff proposed its adjustment because USWC's Oregon intrastate access lines have grown steadily in number since 1988. Staff believes that its estimate of continued average growth of 3% per year while rates from this docket are in effect is conservative.

Staff notes that Oregon is one of the ten fastest growing states in the nation in terms of population. USWC provides 1.2 million access lines in Oregon. As of February 1996, USWC was receiving nearly 36,000 service requests monthly from customers wanting new or additional lines. Staff points out that that USWC also introduces new services and products, which expands the local telecommunications markets. USWC's 1996 revenues from services such as Caller ID, Call Waiting, and data networking services increased 50% or more over 1995. There is also a growing customer demand for existing services, such as second residential lines. Staff cites the record to show that USWC experienced a growth rate of more than 30% in additional residential access lines for the 12 months ending in September 1996.

In response to USWC's contention that the Telecommunications Act of 1996 jeopardizes the stability of USWC's local revenue per access line, Staff notes that current growth figures set out above belie that argument. Staff also points to the following data in the record:

- In 1995, USWC experienced a 4.2% increase in access lines and a 6.8% increase in local service revenues over 1994.

- For first quarter 1996, USWC experienced a 4.8% increase in access lines and a 9% increase in local service revenues over the same period in 1995.

- For second quarter 1996, USWC experienced a 4.9% increase in access lines and a 9.6% increase in local service revenues over the preceding 12 months.

- For third quarter 1996, USWC experienced a 5.1% increase in access lines and a 9.3% increase in local service revenues over the preceding 12 months.

- USWC is also generating strong growth in revenues from value added services such as Caller ID, Call Waiting, Voice Messaging, and data networking services.

Staff points out that its proposed 3% growth rate is substantially less than the increases noted above. Staff also notes that because USWC's local service revenues are increasing at a higher rate than its access lines, its local service revenues per line are also increasing.

USWC has argued that, because of emerging competition, Staff's revenue adjustment for access line growth should be offset by reductions of $8.4 million in its local Oregon service revenues and $2.3 million in toll revenues. Staff argues that these forecasted revenue reductions are based on incorrect assumptions. USWC assumes that it will lose 9 percent market share to resale competition in 1997. That is, access lines that would be sold at retail to end users will become wholesale access lines sold to resellers. USWC projects a confidential percent of those lines to be residential access lines. Staff argues that this assumption is dubious. Staff argues that few, if any, competitors have plans to market local exchange services to residential customers in the near future. Therefore, Staff contends, USWC's forecasts about the impact of competition on its revenues during the period when rates will be in effect are greatly overstated.

Staff asserts that USWC's revenue reduction forecasts also contain other incorrect assumptions. For instance, USWC used $12 as the monthly rate for its unbundled local loop (also called the basic network access channel, or NAC). By Order No. 96-283, however, the Commission revised the monthly rate for USWC's basic NAC from $11.95 to $16. Order No. 96-283 at 10-11; Appendix C at 1. Staff notes that USWC also used a 25% wholesale discount for its retail services and products, whereas USWC has neither given nor offered that large a discount to any competitor in Oregon.

Disposition. USWC's misunderstanding of this issue has led the company to argue against a position that Staff has not taken. Trends in average revenue per access line and average expense per access line are not at issue in this adjustment. At issue is whether the number of USWC access lines is growing at a rate that justifies an adjustment to revenue requirement to recognize that growth.

The record contains strong evidence that USWC access lines are growing at a rate well above the 3% adjustment Staff proposes. It is reasonably certain that this growth rate will continue during the time rates from this docket are in effect. [39]The record also shows that USWC revenues from local access are increasing at a rate above the access line growth rate.

We are also persuaded by Staff's argument that the competition USWC foresees will be slow to develop. We cite UM 351, Order No. 96-283 at 6:

> As we have previously stated, the revenue loss scenarios advanced by the [local exchange carriers] incorporate numerous assumptions regarding the timing and rate of competitive entry, the number and type of product offerings, customer willingness

[39] USWC again asserts that the standard for accepting adjustments to the test year is that the changes be "known and measurable." As we discussed at Issue 1a(1) above, the correct standard for these adjustments is that they be reasonably certain. That standard is met here.

> to change carriers, and changes in the overall market demand for telecommunications services. We do not think it is productive to engage in such speculation, especially when competition for many services has not even begun in the event of a significant impact on revenues, a [local exchange carrier] may seek immediate revenue relief in the form of an interim rate increase.

Finally, we agree with Staff that USWC's projections with respect to the cost of the unbundled NAC and the discount rate for wholesale services and products are mistaken. We are also satisfied that Staff has refuted USWC's argument about double counting and overlap between Issue 8j and Issue 6c.

We conclude that Staff's pro forma adjustment to recognize USWC's continuing growth in access lines is reasonable to keep USWC from overearning and should be accepted.

Issue 8k: Marketing Accrual Reversal

Staff reviewed accident and damage claims accrued and paid by USWC and recommended a $529,375 decrease in total Oregon operating expenses. Staff's adjustment represents the actual level of claims paid during the historical period, January through September 1995, annualized.

USWC maintains a reserve account to recognize the accident and damage claims that will likely be filed against the company. During the test period, USWC accrued $833,000 per month to the account for a nine month total of $7,497,000. The company paid out $2,743,000 from the reserve for the same period. Staff adjusted for annualization, for Oregon's share, and for the disparity between the amounts being accrued and the actual amounts paid.

USWC objects to Staff's adjustment and requests that the amount of claims paid for the last three months of 1995 be included. These months show an additional claims paid amount of $6,582,000. USWC argues that its analyst erred in the first response to Staff's data request, and asks that the Commission consider the entire year's data on accruals and cash payments.

Staff responds that USWC previously indicated that the January to September 1995 level of paid claims is representative of the ongoing level of claims. Staff also contends that the data offered by USWC for claims paid for the last three months of 1995 are highly inconsistent with confidential claims paid data for 1994 and 1996. Therefore, Staff considers USWC's data for the last three months of 1995 unreliable or unrepresentative of claims likely to be paid in the future.

We conclude that the additional claims paid amount of $6,582,000 is not representative of claims likely to be paid during the time rates from this docket are in effect. We accept Staff's adjustment.

Issue 8l: Information Management Systems

This issue concerns two adjustments to USWC's revenue requirement to reflect the reduced expenses due to two recently completed information management projects: (1) SAVER time reporting and (2) bill reformatting. Staff proposes a decrease of $1,185,365 in total Oregon operating expense to account for these savings.

SAVER Time Reporting. This is a project that now allows certain USWC outside plant personnel to spend less time completing work time reporting cards. The project was implemented in Oregon during the fourth quarter of 1995. Staff included the savings achieved by this project, although it was implemented after the historical test period, because that was consistent with Staff's methodology of recognizing such events. Staff calculated its adjustment of $492,827 from information provided by USWC.

USWC argues that Staff's adjustment double counts expense reductions and distorts the test year. First, USWC charges that Staff makes no test year adjustments for increased expenses, and then, when Staff proposes to adjust the test year for specific productivity improvements, it counts expense reductions again. USWC argues that Staff proposes no adjustment to operating expenses due to growth. USWC contends that 1996 maintenance expenses increased rather than decreasing. Maintenance expense, which SAVER would impact, was higher in 1996, the time period when SAVER was in effect.

Staff responds that USWC failed to recognize that SAVER (like bill reformatting) was implemented before the time rates are likely to be in effect. Therefore, it is appropriate to recognize this historical productivity improvement. Staff notes that it has allowed USWC a reasonable level of ongoing expense to make further information management productivity improvements.

Disposition. We conclude that Staff is correct in its response to USWC's double counting argument. Because SAVER was implemented before the time rates from this docket became effective, it is a historical event that will reduce expense during the rate period. If maintenance expense is increasing, as USWC alleges, that is due to factors other than SAVER. Staff's adjustment is appropriate and should be adopted.

Bill Reformating. This adjustment concerns postage savings. USWC estimates that changes to its billing statement will result in postage savings of seven cents per residential bill. The billing project was implemented in the second quarter of 1996. Staff argues that the effect of this program is known and measurable. Staff contends that it should be recognized as an adjustment to the test year. Staff calculates the Oregon portion of this savings to be $692,538.

USWC objects to this adjustment because it is based on an estimate. USWC proposes an adjustment of $156,420 instead, asserting that Staff's adjustment is too high.

Staff responds that the estimate is specific to bill reformating and that it comes from the company. Staff points out that USWC's recommended adjustment is also an estimate. It is based on total company postage expense that has been allocated to Oregon and is not specific to bill reformating. USWC's analysis reflects other causes for expense changes, such as the weight of bill inserts. Further, the amounts included in USWC's analysis represent more than just savings attributable to residential bills. Moreover, USWC's analysis fails to account for the fact that the bill reformating project was implemented in different states during different times, because it relies on total company amounts.

Disposition. We conclude that Staff's adjustment should be adopted. It accounts for reasonably certain reductions in expense arising from USWC's bill reformating project. The amount underlying the adjustment comes from USWC, so the company should not be heard to complain of its reliability.

Issue 8n: PUC Fee Increase

In the adjustment, Staff proposes to add the effects of a projected 1997 increase in the PUC fee. Whether this adjustment is accepted or not depends on whether we adopt Staff's forecast adjustments that restate the test year to August 1997. We do adopt Staff's forecast adjustments; therefore, this adjustment should be accepted.

Issue 9, Service Quality and Reengineering. The findings regarding Issue 9a , 9b, and 9c at pages 83-93 of Order No. 97-171 are readopted.

Issue 9c, Service Quality. Staff added Issue 9d, New Plant Investments and Related Costs, for settlement purposes; see the companion to this order, Order No. 00-190. That addition changed the effect of Issue 9c on USWC's revenue requirement. The discussion at pages 93-101 of Order No. 97-171 is readopted, but the amounts shown in Appendix A, Column 52, are amended to include the Issue 9d effects on the service quality adjustment. The new amount is shown in Appendix B to Order No. 00-190, Column 53.

ISSUE 9: SERVICE QUALITY AND REENGINEERING

Disputed Issues:

- *Issue 9a, Service Reengineering Costs (Adjustment 50[*])*. The recorded data include large service reengineering costs. Staff normalized the test year as if service reengineering had not occurred. USWC disagrees about the need for this adjustment, claiming that it is a disallowance. Staff believes these are nonrecurring costs that should be normalized to properly state USWC's ongoing cost structure. *See* Issue 1a(1), Test Year.

- *Issue 9b, Extraordinary Expenses (Adjustment 51[#]).* Staff removed extraordinary customer service, cable and wire facilities, reported trouble testing, and pole maintenance expenses that will not be part of USWC's ongoing cost structure. Staff has excluded accelerated pole testing expenses from this adjustment. USWC disagrees about the need for normalizing and pro forma adjustments. *See* discussion at Issue 1a(1) above.

- *Issue 9c, Service Quality (Adjustment 52[+]).* Due to continuing service problems, with no quick solutions in sight, Staff recommends using the low end of the return on equity range (10.2%). USWC disagrees with Staff's adjustment.

[*] Issue 9a is now Adjustment 51 of Appendix B to Order No. 00-190.
[#] Issue 9b is now Adjustment 52 of Appendix B to Order No. 00-190.
[+] Issue 9c is now Adjustment 53 of Appendix B to Order No. 00-190.

Issue 9a: Service Reengineering Costs

Background. USWC's reengineering program officially began in September 1993. It was scheduled to end three years later but was extended and will now end in 1997. U S WEST Communications Group described the reengineering plan recently as follows:[40]

> The Communications Group's 1993 results reflected an $880 million restructuring charge (pretax). The related restructuring plan (the "Restructuring Plan") is designed to provide faster, more responsive customer services while reducing the costs of providing these services. . . . The Communications Group has consolidated its 560 customer service centers into 26 centers in 10 cities and plans on reducing its work force by approximately 10,000 employees. All service centers are operational and supported by new systems and enhanced system functionality.
>
> The Restructuring Plan is expected to be substantially complete by the end of 1997. Implementation of the Restructuring Plan has been impacted by the growth in the business and related service issues, new business opportunities, revisions to system delivery schedules, and productivity issues caused by the major rearrangement of resources due to restructuring. These issues will continue to affect the timing of employee separations.
>
> The Communications Group estimates that full implementation of the 1993 Restructuring Plan will reduce employee related expenses by approximately $400 million per year.

[40] Source: *U S WEST Communications Group, 1995 Financials*, Management's Discussion and Analysis of Financial Condition and Results of Operations, p. 6. In this passage, the reengineering plan is called the restructuring plan.

The consolidation involved in USWC’s reengineering program included customer service upgrades (also termed resystematization by several witnesses); employee effects such as termination, relocation, hiring, and increased overtime; and real estate transactions.

As the passage from the Communications Group Financials above indicates, USWC established an $880 million reserve account for the reengineering program expenses and charged such expenses to the reserve under the SEC’s guidance. The company also set up an internal governance committee to administer the actual financial accrual for SEC purposes. The committee was created to ensure that only reengineering program expenses, as defined by accounting rules, were charged to the reserve. When the reengineering program was implemented, USWC’s employees were instructed to charge certain expenses to the reserve. To help track these charges, USWC made a change to the indicator in the responsibility code to identify the reengineering program costs. USWC instructed its employees to charge nonrecurring expenses, not ongoing expenses, to the reserve. USWC wanted to separate business as usual costs from reengineering program costs so that reengineering costs could be audited (Staff Exhibit 76).

Staff’s Proposed Adjustment. Staff argues that for the period January through September 1995, USWC’s costs were substantially higher than for a normal period. That period coincides with the peak of the reengineering implementation period. The costs in the reengineering period included a) nonrecurring costs to implement reengineering (Issue 9a) and b) extraordinary expenses resulting from the movement of work functions, the introduction of new work processes, and the work disruption caused by reengineering implementation activities (Issue 9b).

Staff proposes a $33,840,141 decrease in USWC’s total Oregon operating expense due to USWC’s service reengineering program. This amounts to a decrease of $25.6 million in intrastate revenue requirement. The costs involved in this adjustment are the costs USWC incurred to implement reengineering (e.g., system development, employee related costs, and support costs). Staff asserts that reengineering is a unique change in USWC's business practices that entails large nonrecurring costs and equally large forecasted future savings. Staff argues that it is unlikely that USWC will undertake another reengineering plan of this type in the foreseeable future. Therefore, Staff argues that these are nonrecurring costs and should be removed from the test year.

Staff's Method. To calculate the effects of the reengineering program on the ongoing cost structure of the company, Staff reviewed USWC's results of operations. As detailed above, USWC had implemented procedures to identify and separate reengineering expenditures from business as usual expenditures. Staff calculated its service reengineering cost adjustment amount by removing nonrecurring costs to establish an appropriate recurring cost level. To do so, Staff normalized the historical period to appear as if USWC had not undertaken its reengineering efforts. Staff removed the reengineering costs incurred during the historical test period.

Staff used the information recorded by functional category under the Uniform System of Accounts, codified at 47 C.F.R. 32, to understand the type of expenses being charged to the reserve and to ensure that USWC's remaining expenses represented a reasonable ongoing level.

Staff would have recommended removing any reengineering related savings realized during that period. However, Staff believes that USWC did not realize such savings during the historical period. To deal with future savings in calculating the service reengineering cost adjustment, Staff recommends an offset. Staff argues that during the historic test period, USWC made reengineering related capital investments in anticipation of savings. To establish the cost level that would have occurred in the absence of reengineering, Staff exactly offset the reengineering capital costs in the test period with a portion of future savings.

The portion of future savings involved in the offset is relatively minor compared to anticipated savings from the program. USWC estimates that 1998 reengineering savings will be $400 million (*see* the Communications Group Financials, above). Staff figures the Oregon allocation of that amount at a conservative 8 percent or $32 million. Staff points out that apart from the portion allocated to offset capital costs, USWC shareholders will receive the remaining future savings until rates are reset.

Staff maintains that its exclusion of reengineering expenses from the test year results of operations leaves USWC with a reasonable level of ongoing expense. To check the reasonableness of the ongoing level of expense for the company after Staff's reengineering adjustment, Staff reviewed the expense trend for the five accounts with the most significant reengineering expense during the test period. These five accounts represent over 75 percent of the reengineering expense that was removed from the historical period. Staff then compared the account balances for these five representative accounts from prior years to the same five accounts for the test year. These comparisons showed that USWC still had a reasonable level of ongoing expense after the reengineering program adjustment.

USWC's Position. USWC opposes this adjustment, arguing that the reengineering costs are recurring and that reengineering is a generic, ongoing program. USWC also argues that there is no basis in law or fact to disallow its prudently incurred expenses and investment related to restructuring to improve efficiency. USWC alleges that Staff has not proved that the expenses it recommends disallowing are nonrecurring, and has not proved that they amount to $33 million.

USWC asserts that uncontradicted evidence shows that test year levels of expense and investment for the costs at issue are representative of historic trends and are expected to continue. USWC argues that Staff bases its proposed disallowance on accounting documents, yet concedes that accounting documents cannot prove that an expense is nonrecurring.

USWC points out that the expenses at issue consist primarily of two major items, employee separations and systems development and upgrade. Many of these costs were incurred to improve existing systems and processes. USWC argues that it has a long history of incurring expense to upgrade its systems, consolidate operations, and downsize work force. These same expenses were ongoing at approximately the same levels before the present reengineering program was announced. USWC contends that it submitted substantial evidence that restructuring efforts will continue to be a significant ongoing expense, although they will not always be called reengineering.

USWC also argues that its consolidation and systems development efforts are not completed. USWC cannot maintain service or compete in the market place without continuing systems development. Thus, the company argues, these expenses will recur. Further, historic data demonstrate that downsizing the work force does not result in expense reductions, because of wage increases and new hires in other areas. In addition, the company argues that reduced expenses achieved by reengineering are offset by inflation and changes in other areas of operations.

Moreover, USWC contends that process improvements, systems development, and consolidation of business offices have improved operations to benefit Oregon ratepayers. For instance, business office access has improved.

Finally, USWC argues that Staff’s testimony in other areas of the case contradicts its position on this issue. In Issue 8f, Income Tax Refund, Staff relied on historic trends to support its contention that an event was recurring. USWC asserts that for that issue, the historic trend was substantially less supportive of a recurrent event than the historic trend of expenses associated with restructuring. USWC accuses Staff of being result oriented and using historic trends when it would reduce revenue requirement but ignoring them when it would increase revenue requirement.

USWC proposes headcount data--that is, data regarding the number of people it employs at particular time periods--rather than accounting data to indicate the appropriate expense levels. USWC uses this argument in three ways:

1) USWC argues that Staff's overall projected decline in expenses is tantamount to the departure of 1,600 Oregon employees (when there were only 3,786 Oregon equivalent employees at the end of December 1995);

2) the levels of employee paid exits under the reengineering program are the same as prior to the reengineering program, showing that the reengineering program is recurring; and

3) employee levels did not increase in 1994 and 1995 during the reengineering program period.

***Disposition*.** We conclude that USWC's service reengineering program represents a fundamental change in the way USWC delivers service. The program involves substantial consolidation and movement of employees as well as development and implementation of computer systems. USWC has consolidated 560 service centers into 26 and is reducing its work force by approximately 10,000 employees. This is a major and unique program that is not likely to recur. We base our conclusion on the Communications Group Financials passage above, the statements of several USWC witnesses that the program will end in 1997, and the fact that USWC maintained its accounting records to separate reengineering charges from business as usual. We also note that the record contains these comments from pp. 24-25 of USWC's booklet of comments to the 1995 NARUC Summer Committee Meetings in San Francisco:

> As announced in September 1993, the company expects a total of 9,000 jobs to be eliminated by 1997. . . . We anticipate that by August, 1995, about 95 percent of the people with jobs in the new reengineered centers will be working in

> them. . . . We’re on target for completion of reengineering in 1997. All of the 26 reengineered centers are open.

We find USWC’s attempt to downplay the importance and reliability of its accounting information unpersuasive. USWC was required by federal law to accurately maintain the information Staff used to isolate reengineering expenses. Staff properly relied on USWC’s accounting data and information from its investigation to determine that the reengineering costs were nonrecurring and to calculate the amount of the disallowance.

Staff’s adjustment does not ignore the reengineering program, as USWC charges, but removes the nonrecurring costs from revenue requirement. However, Staff allows USWC to offset the removed costs by retaining virtually all the savings the company estimated would arise from the reengineering program. This is a generous approach. In the past (Order No. 92-1562), the Commission approved a settlement agreement that removed the nonrecurring implementation costs and included all savings arising from that nonrecurring event.

USWC argues that the reengineering program will not result in expense reductions because of wage increases and new hires in other areas, inflation, and changes in operations. These factors are not specific to reengineering but are costs that face any company. Staff’s adjustment does not affect cost increases not associated with the reengineering program. We note that USWC projects $400 million of savings in 1998 associated with the reengineering program (*see* Communications Group Financials passage above).

USWC argues that Staff took a different position with regard to recurring and nonrecurring events in Issue 8f. We disagree. The income tax refund involved in that issue is an intermittent event, not a one time occurrence such as the reengineering program.

USWC argues that we should rely on its historical headcount data rather than on its accounting records to judge the costs involved in the reengineering program. Headcount data is a poor substitute for accounting data, for the following reasons. First, USWC is not able to account for changes in employee levels, leaving a residual of 2,051 unexplained employees in 1995. Second, headcount analyses are difficult to make because of changing employee status (full time to part time and back). Third, they are suspect because USWC recently has been required to use extensive overtime and contract labor. USWC also relies on a data systems organization headcount that is subject to change from reorganizations, such as the dismantling of its technologies division. And fourth, headcount information does not reflect the separation of regulated and nonregulated expenses under Part 64.

Staff gives an example of why it considers headcount information unreliable. USWC claims that Staff’s projected decline in expenses is tantamount to the departure of 1600 Oregon employees. That figure is calculated using the comparison of expense per line shown in USWC Exhibit 64. USWC fails to consider that substantial operating expenses underlying its exhibit do not relate to headcount.

We conclude that the reengineering program is a one time event, not an ongoing effort as USWC asserts. The consolidation of 560 service centers into 26 centers will not take place again. Staff’s adjustment follows the Commission policy of removing nonrecurring costs from the test year to establish an appropriate recurring cost level.

We are persuaded that Staff’s reliance on the reengineering accounting data that USWC kept pursuant to federal law was reasonable. USWC’s alternative headcount data are unpersuasive.

Staff is correct in stating that savings from the reengineering program affect the recurring cost level. Staff took the conservative approach of recognizing only the future savings that offset the capital costs in its adjustment. Staff based its recognition on savings estimates provided by USWC. We are satisfied that Staff's adjustment leaves USWC a reasonable ongoing level of expense during the time rates will be in effect. We find Staff's adjustment reasonable and adopt it.

Issue 9b: Extraordinary Reengineering Related Costs

Issue 9b addresses the extraordinary expenses incurred by employee groups that experienced work disruption during the implementation period. The groups include employees that charge the following expense accounts: customer services operations and customer accounting operations (customer services), cable and wire facilities, and reported trouble testing. It also addresses the extraordinary expenses associated with the correction of pole safety violations. Staff recommends reducing USWC's total Oregon operating expense by $8,995,203 to account for these extraordinary expenses, because these costs will not recur at the same high level during the time rates set in this case will be in effect. That results in an intrastate Oregon revenue requirement reduction of $6.6 million.

Unlike the reengineering program expenses (Issue 9a), USWC did not track these extraordinary expenses to specified accounts. Staff reviewed USWC financial statements to determine that reengineering implementation resulted in extraordinary expenses. Staff then compared USWC expenses in prior periods with those from the test period. USWC's financial records show higher costs during the reengineering implementation period. Staff assessed information concerning implementation issues that USWC faced during the historical period, such as resolving computer system errors, dealing with shortages of employees in megacenters that resulted in technician hold time, trying new procedures and then reverting to prior procedures, revising procedures, and extending the length of the implementation period. This information provided specific examples of the causes of higher costs during the historical period.

Staff stresses that the problems USWC encountered in implementing the reengineering program were not due to rank and file employees. Instead, USWC’s front line employees have performed admirably in a difficult work environment. The problems stem in large part from decisions made at the corporate level by USWC executives.

Staff contends that the expenses recorded during the historical period January through September 1995 were affected by activities that will not be a part of USWC’s ongoing cost structure, particularly reengineering implementation expenses and pole maintenance expenses that are higher due to USWC’s response to safety concerns. Staff normalized those costs based on a more representative period, to reflect USWC’s ongoing cost structure. USWC’s financial information supports the view that the test period includes nonrecurring expenses associated with reengineering implementation. In the latter part of 1994, reengineering implementation began to accelerate. As outside plant technicians were affected by reengineering implementation, cable and wire facilities expenses began to increase, and USWC’s service quality experienced a further decline.

Staff points out that reengineering caused a decline in productivity, including computer errors, shortages of employees in megacenters that resulted in technician hold time, and changes in procedures. USWC also lost expertise when approximately 1,000 employees decided not to relocate. USWC underestimated how many people would choose to leave the company. USWC transferred or terminated locally based engineers. USWC field technicians have been required to work substantial amounts of overtime. USWC has deployed substantial numbers of out of state and contract personnel who may be unfamiliar with USWC’s Oregon outside plant. Staff believes that the field technicians have performed admirably under difficult situations. However, it is normal that such situations, particularly prolonged periods of overtime, result in lowered productivity.

The productivity issues related to reengineering directly affected customer services, cable and wire facilities, and reported trouble testing expense. Staff believes that other work functions such as plant administration and engineering were also affected by reengineering implementation activities. The accounts associated with the latter two work functions were more difficult to analyze than the others, because of the clearing of capitalized amounts from those accounts and the level of nonrecurring reengineering implementation expenses in the account balances. Staff therefore elected a conservative approach and limited its adjustment to customer services, cable and wire facilities, and reported trouble testing expenses.

Staff obtained USWC's records for the three categories of customer services, cable and wire facilities, and reported trouble testing expenses. Staff first selected a period (January through June 1994) as representative of ongoing expense levels. This was a period during which work functions were not affected by implementation of the reengineering program. Staff then normalized the January through June 1994 expenses to recognize an August 1994 wage increase and line growth between this period and the period of January through September 1995. Staff compared the normalized 1994 data with the 1995 data to determine extraordinary 1995 wage and other expense amounts and then calculated benefit effects based on extraordinary wages. Finally, Staff removed the abnormally high expenses from the test period.

Staff believes that the allowance for wage and line growth increases is more than adequate for expected cost changes. Staff did not try to adjust the allowance downward for expected factors such as productivity increases and the level of fixed expenses (those that do not vary with changes in line volume). Staff allowed for a large increase even though expenses in general, depending on type and circumstances, may be level or even declining.

Staff considers the nature of the expense increase to be temporary. The additional expenses are primarily overtime and contract labor, not permanent employees. USWC is trying to modify systems and relocate personnel at the same time. It is usual for costs to be higher during this type of implementation period and then return to normal levels. According to Staff, the problems USWC is experiencing can be corrected, and it appears that USWC is taking measures to correct them. The higher costs are related to decisions and reengineering implementation activities directed at the corporate level rather than being related to an increase in the number of USWC permanent Oregon employees or the performance of Oregon employees.

As with Issue 9a, Staff performed a reasonableness check to determine whether its adjustment for extraordinary expenses left USWC with an appropriate ongoing expense level. Staff determined that its adjustment allows a reasonable upward increase in the adjusted categories.

Staff also asked USWC to explain the sharply increasing expenses. USWC argues that its increasing expense trend is due to USWC’s response to service quality problems. Staff does not credit this argument. Staff attributed the trend to reengineering implementation, which it considers the underlying cause, as opposed to a decline in service quality and USWC’s response to it, the symptoms. Staff points out that the increase in service complaints the Commission received from USWC customers coincided with the implementation of reengineering during the latter half of 1994. Service quality did not improve over the course of the historical period.

USWC gave Staff two explanations for the expense increase that, according to Staff, merited further consideration. First, USWC indicated that “customer services other expenses” was increasing due to an increase in postage costs. Staff lowered its adjustment to account for the recurring nature of the postage cost increase. Second, USWC made an accounting change in the second half of 1994 to classify certain locating costs associated with construction activities as expense rather than as capital. Staff did not attempt to normalize for this accounting change because of some uncertainties. That is, unless prior capitalized charges were reclassified from capital to expense, ratepayers are incurring capital costs for prior locating as well as expenses for current locating. Also, due to the effects of reengineering and the lack of financial data, Staff had trouble determining a proper ongoing level of expense associated with this change.

Staff argues that USWC incurred extraordinary expenses during January through September 1995 to address pole safety issues. In March 1994 the Commission approved an agreement between USWC and Staff to eliminate pole safety violations (UM 640). During 1995, USWC continued to correct these safety violations. USWC conducted a public safety inspection of all USWC poles in the state and accelerated the detailed inspection and pole strength testing to 20 percent per year rather than the normal 10 percent per year. Staff recommends excluding the extraordinary pole maintenance costs associated with USWC's correction of pole safety violations.

To calculate the adjustment associated with pole safety issues, Staff excluded expenses associated with the one time public safety inspection of all USWC poles in the state and reduced detailed inspection and pole strength testing expenses from the accelerated rate of 20 percent per year to the normal rate of 10 percent per year. Staff also amended its adjustment to reflect the partial settlement of the pole safety violation issue. *See* Staff Exhibit 84.

USWC asserts that Staff has presented no evidence to support its proposed adjustment, while USWC has produced substantial evidence to disprove Staff's claims. Expense levels for 1996 demonstrate that ongoing levels of maintenance expense are substantially higher than test year levels. The increase is due in part to the increased number of network technicians since the end of the test year, a 26% increase from 898 technicians employed in Oregon in September 1995 to 1,134 in August 1996. USWC notes that it has added these technicians in response to Commission concerns about adequate service in Oregon. USWC also uses its new network technical data as an argument against Staff's service quality adjustment (Issue 9c).

USWC also charges that Staff failed to present evidence demonstrating that reengineering had the dollar effect on expenses that Staff claims. USWC points out that Staff's proposed adjustment is tantamount to removing 180 network technicians from the payroll. USWC also argues that Staff's adjustment distorts the test year.

Staff responds that USWC has not shown that its recent employment of over 200 network technicians justifies increasing the overall cost level in the rate case. Staff argues that the Commission should not rely on headcount data; it is unreliable and subject to misuse (see discussion at Issue 9a above). Staff also notes that these data were introduced for the first time in USWC's reply testimony. The data are unverified, and Staff asserts that verification would be difficult and time consuming. Moreover, the relevant inquiry is how the new hires impact overall expense levels. Staff notes that in its brief, USWC claims that all these technicians are employed in Oregon, but USWC witness Carl Inouye does not make that claim in his testimony. Thus, Staff argues, the record does not establish that all or any of these technicians are working in Oregon. The duties of these network technicians are also unclear. If they are involved in construction, their cost is a capital item, not an operating expense. Nor is there evidence in the record as to how long these employees will stay in Oregon. Staff notes that USWC has deployed out of state employees in the past.

Disposition. For the reasons given above, at Issue 9a, we reject USWC's headcount arguments. We conclude that USWC's network technician figures are unverified and therefore do not accept them to refute Staff's argument.

We find that Staff's adjustment properly removed extraordinary nonrecurring expenses associated with problems in implementing the reengineering program. We find that the adjustment was reasonably calculated and leaves USWC an appropriate level of ongoing expenses. We also find Staff's adjustment with respect to pole safety violation corrections reasonable. We conclude that Staff's adjustment should be adopted.

Issue 9c: Reduced Service Quality

As we stated in Order No. 96-107, at 1:

> During the past four years, U S WEST has experienced a severe increase in service quality problems, relating to both customer service and technical service.

The deterioration in USWC's service quality began during the time when USWC was operating under an AFOR approved by the Commission in Order No. 91-1598. The AFOR was an incentive based plan designed to give USWC pricing flexibility and an opportunity to earn higher rates of return within a broad range. The Commission approved the AFOR plan "contingent upon USWC's compliance with the quality of service standards as of April 1, 1991." Order No. 91-1598 at 22. Staff certified that USWC satisfied that requirement. *Ibid*.

USWC represented, and we expected,

> that [this] incentive-based regulatory approach adopted in this order should motivate USWC to improve efficiency, modernize its infrastructure, and provide services which meet the challenges of the changing telecommunications environment. These benefits will be achieved without sacrificing . . . the quality of service that Oregonians have come to rely on. Indeed, the new regulatory framework will benefit customers by providing rate stability for essential services, the potential for revenue sharing, improved service quality, and continued access to state-of-the-art telecommunications services.

Order No. 91-1598 at 1, 30.

Our expectations have not been met. Between April 1991 and October 1995, trouble report rates increased in 66 of USWC’s 77 Oregon wire centers. In some instances, these trouble reports more than doubled. Further, trouble report rates in 49 of USWC’s Oregon wire centers increased from October 1995 levels in 1996 (average of March, April, and May 1996). USWC held orders for primary lines in Oregon have risen from an average of 66 per month in 1991 to 172 in 1995 and to 261 in July 1996. USWC’s primary held orders delayed more than 30 days have risen from an average of 23 per month in 1994 to 35 per month in 1995 to 107 in July 1996. USWC has also experienced problems with other measures of service quality the Commission uses. These are detailed in the Staff report attached as Appendix A to Order No. 96-107 terminating USWC’s AFOR. Finally, the number of complaints received by the PUC Consumer Services Division regarding USWC’s service has increased by a factor of ten, from an average of 23 per month in 1991 to 228 per month during the first six months of 1996.

USWC Oregon Vice President Chuck Lenard indicated to the Commission at the March 27, 1996, special public meeting that USWC is unlikely to be able to restore its service quality to the pre-AFOR levels soon. Service quality improvement will take considerable time. Mr. Lenard also indicated that USWC’s service quality problems were due in large part to the condition of USWC’s network infrastructure. Moreover, Mr. Lenard told the Commission that USWC has capacity problems in Oregon because the company underestimated the demand for USWC services.

Staff believes that it is unlikely that USWC will be able to remedy its service quality problems during the time when rates from this docket will be in effect. Staff therefore recommends that we adopt the low end of Staff witness John Thornton’s return on equity range to reflect the reduced level of USWC’s telecommunications service quality. Staff notes that if USWC restores its service quality to April 1991 levels, it would be appropriate to use the midpoint of Staff’s return on equity range to determine USWC's revenue requirement.[41] Staff argues that this condition is reasonable, because the highly reliable digital technology in USWC's network today makes it easier for USWC to provide the level of service it provided in April 1991.

Staff recommends that the Commission take the following actions with respect to Issue 9c:

1. Use the low end of Staff's reasonable return on equity range in determining USWC's revenue requirement.

2. Order USWC to restore service to April 1991 levels.

3. Order USWC to continue providing monthly service reports specified in the AFOR agreement until its service has been restored to April 1991 levels.

4. Adopt USWC's April 1991 service levels as the reference points for the levels of service that would justify using the midpoint of Staff's return on equity range in determining USWC's revenue requirement.

USWC opposes Staff's proposed adjustment. USWC maintains that it has been investing at record levels and has added service technicians to meet the new service requirements. USWC also claims that it has improved service levels in Oregon. To illustrate this claim, USWC points out that 80% of calls into customer centers have consistently been answered within 20 seconds since October 1995. USWC also notes that access to repair centers has improved, the percentage of missed commitments has declined, and repair cycle times are down.

[41] We recently adopted new service quality standards for Oregon's local exchange companies (Order No. 96-332, amending OAR 860-023-0055). In light of these new standards, Staff recommends that the Commission use the middle of its return on equity range in determining USWC's revenue requirement in the future, if the utility's service meets or exceeds the standards in the amended rule.

USWC argues that Staff's reliance on the April 1991 service quality standards is misplaced. Those standards, USWC argues, were relevant only as benchmarks in Order No. 91-1598 establishing the AFOR. Therefore, USWC contends, the limited purpose for which the April 1991 performance levels are relevant is no longer applicable. USWC maintains that it has already been penalized for falling below the April 1991 service quality levels by termination of the AFOR, which cost it its pricing flexibility and the ability to earn at higher levels. USWC argues that if the Commission adopts Staff's recommendation, it will be penalized again and will continue to be penalized as long as rates from this docket are in effect.

USWC also believes that Staff has unfairly singled out USWC for the requirement that service be kept at April 1991 levels. USWC contends that this selective creation and application of the law only to USWC is akin to a bill of attainder, US Const. Art. I, §10, and violates USWC's right to equal protection of the law.

Moreover, USWC contends that the April 1991 performance levels were the highest ever achieved by the company, and are therefore not a reasonable basis for evaluating current and future service quality. USWC argues that there is no evidence that the April 1991 levels produce an appropriate level of service. Staff also proposes service levels that must be achieved in nine categories before USWC will be allowed to earn at the midpoint of the return on equity range. Currently, USWC notes that there is no standard as to five of the nine categories. The levels are defined only as those achieved in April 1991. Four of the nine measurements were not reported to the Commission in April 1991, however, so there was no basis to conclude that USWC met them then. As to those measurements that were recorded, USWC did not achieve them in April 1991. In almost all instances, the levels of service described by Staff are higher than USWC was actually achieving in 1991.

USWC argues that Staff proposes to adopt in this proceeding the standards by which to measure the company's performance and to apply those standards retroactively so as to penalize the company for failing to achieve them. USWC considers this an obvious example of an ex post facto action, which is prohibited by Article I, § 10 of the U.S. Constitution. USWC also argues that there is no competent evidence on which to assess a rate of return penalty. USWC argues that there is no suggestion in the record that USWC failed to meet the service standards set forth in the Commission's rule. USWC also asserts that the Commission may not impose a penalty for service quality without a known service quality standard. *State ex rel. Utilities Comm'n v. Carolina Water Serv., Inc.*, 439 S.E.2d 127 (N.C. 1994).

USWC also maintains that the Commission has no statutory authorization to penalize a utility by denying it a rate of return which Staff would otherwise find appropriate. Staff has recommended an 11.6% rate of return but for service quality considerations. USWC cites several cases that hold that quality of service cannot lawfully be used as a factor to reduce a utility's rate of return.[42]

USWC contends that specific measures are already in place to address any service quality problems. Order No. 96-107, which terminated the AFOR, prescribed the specific measures that USWC must undertake to improve service quality. These measures include implementation of USWC's cellular telephone loaner program and an out of service credit. Those provisions, USWC believes, address the specific service quality issues and provide focused relief to affected customers. USWC has offered to make the existing program permanent until the next rate case. USWC argues that penalties should directly benefit those who have been inconvenienced, as USWC's current plan does. USWC also argues that Staff's proposed penalty would deprive the company of the financial resources it needs to achieve further service quality improvements.

[42] *South Central Bell Telephone Co. v. Utility Regulatory Commission,* 637 S.W. 2d 649, 654 (Ky. 1982); *Florida Telephone Corp. v. Carter, Fla.,* 70 So.2d 508, 510 (Fla. 1954); *In re General Telephone Co.,* 652 P2d 1200 (N.M. 1982).

Finally, USWC argues that Staff has shown no relationship between the amount of the recommended penalty and the nature of service quality concerns. USWC cites *South Central Bell Telephone Company v. Utility Regulatory Commission*, 637 S.W.2d 649, 653 (Ky. 1982) for the proposition that it is arbitrary and subjective to impose a penalty grossly disproportionate to documented service deficiencies. Here, USWC contends that Staff has identified technical noncompliance only in three small exchanges. USWC also contends that customer calling volumes do not correlate with service quality. USWC argues that the proposed adjustment is based on complaints by only 1% of its customers. USWC recommends that we reject Staff's proposed service quality penalties.

***Disposition*.** ORS 759.035 provides:

> Every telecommunications utility is required to furnish adequate and safe service, equipment and facilities, and the charges made by any public utility for any service rendered or to be rendered in connection therewith shall be reasonable and just, and every unjust or unreasonable charge for such service is prohibited.

ORS 756.040 empowers the Commission in part as follows:

> (1) . . . [T]he commission shall represent the customers of any public utility or telecommunications utility and the public generally in all controversies respecting the rates, valuations, service and all matters of which the commission has jurisdiction. In respect thereof the commission shall make use of the jurisdiction and powers of the office to protect such customers, and the public generally, from unjust and unreasonable exactions and practices and to obtain for them adequate service at fair and reasonable rates.
>
> (2) The commission is vested with power and jurisdiction to supervise and regulate

> every public utility and telecommunications utility in this state, and to do all things necessary and convenient in the exercise of such power and jurisdiction.

As these provisions make clear, we have authority to set service levels and establish reasonable rates for that service. We also have authority to set rates to reflect the level of service a utility provides. As the Oregon Court of Appeals held in *Garrison v. Pacific Northwest Bell*, 45 Or App 523, 531 (1980), "[r]ates, service levels, and the remedy for . . . service failures are inseparable." *See also West Coast Tel. Co.*, 27 PUR 3d 489, 497 (OPUC 1958) (OPUC held that a telephone company's inadequate service justified a rate of return "in the lower range of the zone of reasonableness").

USWC claims that its service substantially meets the standards in OAR 860-023-0055 (1995). Therefore, USWC argues, no rate of return adjustment should be made based on service considerations. We disagree. Our service quality rule was based largely on technical standards. Customer service problems are at the heart of USWC's current service quality problems. We amended the rule by Order No. 96-332, because some of the technical standards in it were outdated and because it did not contain important customer service standards.

Our service quality rule is not our only redress for poor utility service, however. As the statutory provisions above and the *Garrison* case make clear, the reasonableness of rates depends in part on the quality of service that the utility provides. We find that USWC's revenue requirement should reflect the lower level of service the utility is currently providing.

USWC argues that it is inappropriate to hold the company to the April 1991 standard for service. USWC argues that the only relevance of the service quality as of that date is to measure service quality in terms of the AFOR. Again, we disagree. We approved the AFOR plan because we expected it to result in long range benefits to ratepayers: improved efficiency, modernized infrastructure, and the provision of services that meet the challenges of the changing telecommunications environment. We expected those benefits to accrue without sacrificing service quality. Order No. 91-1598 at 1, 30. As a condition for granting the AFOR, we asked USWC to maintain the quality of service it was providing in April 1991.

Instead, Oregon ratepayers are now worse off than they were in 1991, and perceive themselves to be worse off than they were in 1994. That is an unreasonable outcome. Technology has improved in the meantime. We consider it a reasonable condition to ask USWC to bring service quality to the level of April 1991 in order to use the midpoint of Staff’s return on equity range in determining USWC’s revenue requirement.

USWC claims that there have been material improvements in its service quality. USWC cites improved access to customer and repair centers, fewer missed commitments, and shorter repair cycle times. We commend USWC for these improvements, but note that other indicators of service quality are dismaying. We quote from Order No. 96-339 at 1-2:

> Order No. 96-107 terminated USWC’s alternative form of regulation (AFOR) plan, and the order also adopted a stipulation that addresses USWC’s service quality problems regarding held orders for primary and additional access lines, and delays in restoring access line service to customers.
>
> There has been no substantial improvement in USWC’s service quality in these regards since the date Order No. 96-107 was entered (April 24, 1996), based upon customer complaint information received by the Commission. Complaints from USWC customers continue to come to the Commission’s Consumer Services Division at an alarming rate. Commission records show that USWC customers are as dissatisfied with the company’s service now as they

were in April 1996, that the customers are less happy with USWC service now than they were during calendar year 1994, and that USWC service is perceived to be significantly worse than that provided by other utilities regulated by the Commission.

USWC has entirely too many held orders. In April 1996, the company had 283 primary held orders. In October, the primary held order figure rose to 366.

For the second and third quarters of 1996, USWC was clearing approximately 80 percent of its out of service reports within 48 hours. In recent weeks, the figure has been 50 to 70 percent. Historically, the percentage of reports cleared has dropped when Oregon’s rainy season begins because of wet cables cracking, which may explain the most recent drop. Commission Staff believes that the service restoral standard should be that at least 95 percent of all reports are to be cleared within 48 hours. Because of the cable problem described above, USWC is unlikely to be close to compliance with that standard for at least several months.

USWC mentions that it is unnecessary for the Commission to "penalize" it by choosing a return on equity at the low end of the range, because the Commission has service quality remedies in place. *See* Order No. 96-339. We respond that the measures in that order are remedial. USWC has had ample notice that we expect its service quality to improve, not merely that we require it to provide redress for the symptoms associated with its poor service.

USWC cites several cases holding that a commission may not impose a penalty for poor service in a rate case. *See* Footnote 45 above. In *South Central Bell*, the Kentucky Commission was enjoined from reducing the utility's rate of return because of alleged poor service. The Kentucky Supreme Court found that a reduction in what was originally determined to be an adequate rate constituted a penalty beyond the scope of the Commission's authority. This holding is similar to the holding in the *Florida* case and the *General Telephone* case.

The present case is distinguishable on three grounds. First, the cases cited are state court cases. In our state, the Oregon Court of Appeals has reached a different conclusion about the relationship between rates and service, as the language from *Garrison* quoted at the beginning of this section shows.[43] Second, in the present case Staff has recommended a point within a reasonable range of return on equity. Any rate within the range is adequate to allow USWC to earn a reasonable return on equity. Therefore, USWC's arguments that the low end of the range will not permit it sufficient funds to improve its network are groundless.

Third, the choice of the low end of the reasonable range is not a penalty. It is not punishment for failure to meet service expectations in the past. As USWC noted, early termination of the AFOR was the consequence of

[43] USWC argues that this case is not on point because the court found that the utility had not violated the "adequate service" statute. The point is, however, that the court, in making its determination, articulated the principle that rates and service are interrelated.

USWC’s failure to meet the April 1991 service quality standards. That issue is resolved. Ratemaking, however, is prospective in nature. *See, e.g.,* Order No. 87-407 at 11-12. Staff’s proposed adjustment is also prospective. Staff determined that “USWC is unlikely to restore its service quality to pre-AFOR levels during the period in which rates resulting from this proceeding will be in effect.” Staff/7, Birko/1, 3, 6-7, ; Staff/8, Birko/4-5; Staff/42 and 43; Mr. Lenard’s comments at the March 27, 1996, PUC special public meeting (officially noticed Tr 15-16.) Our reduction in the return on equity is based on our understanding that USWC’s service during the period when rates will be in effect will be less satisfactory than it was six years ago.

USWC argues that we cannot choose the low point in the range of reasonable return on equity because there is no known standard below which USWC’s service quality has fallen. ***Carolina Water Serv., Inc.***, ***supra.*** Throughout the term of the AFOR, we held up USWC’s own April 1991 service quality achievement as the standard which it must meet. In Order No. 96-107 terminating the AFOR, we again stressed to USWC the importance of improving its quality of service. That order specifically directed the company to continue to file the monthly technical service quality reports that it had filed under the AFOR. That order originally foresaw continuing the reports until OAR 860-023-0055 was amended, but the Commission subsequently extended the period of time during which USWC must file the reports required indefinitely (***see*** Order No. 96-338 at 4, Ordering Paragraph 4).

We believe this is a reasonable and known standard to continue to apply. It is reasonable because USWC had already met that standard before the AFOR was implemented.[44] It is known because we have repeatedly held it up as the standard of service USWC must meet, both during and since the

[44] USWC argues that it did not actually meet the April 1991 service quality standards. Staff certified that it did meet those standards. ***See*** Order No. 91-1598. USWC’s assertion that the certification was false is a collateral attack on that order and is inappropriate in this forum.

AFOR. USWC's ex post facto argument therefore fails.

As to USWC's equal protection argument, the company has not shown that other, similarly situated companies have received different treatment. USWC argues that it is subject to a standard that is not applied to other telecommunications utilities, the April 1991 standards. The history that led to approval of USWC's AFOR, development of the service quality standards under the AFOR, termination of the AFOR, and continued imposition of the AFOR service quality standards is unique. As we state below, in future rate cases, USWC will be held to the same set of standards that govern service for all telecommunications utilities, those set forth in OAR 860-023-0055. For purposes of this rate case, we look to the April 1991 standards to assess USWC's performance because of the AFOR and USWC's agreement to that set of standards under the AFOR.

USWC contends that Staff's proposed adjustment is grossly disproportionate to the consequences, because it is based on complaints by 1% of the company's customers. USWC's argument misses the point. First, we have no way of knowing how many customers who receive inadequate service fail to complain of it. Second, and more importantly, the complaints indicate problems with USWC's telecommunications system and delivery of service that may adversely affect the system as a whole and Oregon's infrastructure. Cost cutting, employee reductions, and USWC's reengineering program have reduced USWC's ability to maintain 1991 service levels at a time when the utility is experiencing rapid growth in the demand for its telecommunications services. USWC's ratepayers, present and potential, can expect to be adversely affected by delays in providing access lines or service repairs.

We conclude that Staff's proposed adjustment in the return on equity to 10.2% is reasonable. The adjustment reflects USWC's reduced quality of service, which is not likely to be remedied while rates from this docket are in effect. Staff also asks us to order USWC to restore service to

April 1991 levels and order USWC to continue providing monthly service reports specified in the AFOR agreement until its service has been restored to April 1991 levels. Under Order No. 96-339, USWC is already required to provide those service reports for an indefinite period. It would be redundant to include such a mandate in this order.

Further, Staff requests that we adopt USWC's April 1991 service levels as the reference point for the level of service that would justify using the midpoint of Staff's return on equity range to determine USWC's revenue requirement. We decline to do so. The 1991 service levels are an appropriate measure in this rate case for USWC's failure to provide adequate service. In future rate cases, however, we will judge USWC's service

quality by amended OAR 860-023-0055 (*see* Order No. 96-332). If USWC meets the standards in the new rule, we will find it appropriate to choose the midpoint of a reasonable range for USWC's return on equity.

Issue 10, Final Test Year Separation Factors. The discussion at page 101 of Order No. 97-171 is readopted, but the amounts shown in Appendix A, Column 53, are amended as shown in Appendix B, Column 56, Order No. 00-190.

ISSUE 10: FINAL TEST YEAR SEPARATION FACTORS
Significantly Undisputed Issue:

- *Adjustment 53*[*]*.* Staff and USWC agree that the intrastate separation factors used to initially separate the test year should be modified to include the effects of the sale of exchanges to PTI and the EAS conversions. The final factors depend on the resolution of all disputed expense adjustments. *See* Appendix B, First Stipulation, Paragraph 25.

Issue 11, Refund Procedures. The discussion at pages 101-107 of Order No. 97-171 is readopted except: 1) the interest rate is revised to 8.77 percent; 2) the refund eligibility date is updated from May 19, 1997, to reflect the provisions of the Stipulation adopted as modified in Order No. 00-190 (*see* Appendix A to that order);

[*] Issue 10 is now Adjustment 56 of Appendix B to Order No. 00-190.

3) we update the date when the refund will begin, in accordance with the Stipulation, *supra*; 4) we allow refunds to former customers; and 5) we allow temporary rate reductions and bill credits as provided in the Stipulation, *supra*.

Amount of Refund: The discussion on pages 101-107 of Order No. 97-171 is readopted, but we revise the conclusions to allow refunds to be based on an amount lower than the adjusted test year revenue requirement. *See* Appendix A to Order No. 00-190.

ISSUE 11: REFUND PROCEDURES – PROCESS

Disputed Issue:

Staff believes that USWC should make one time, lump sum credits on customers' bills. USWC should not make refunds for toll usage, but the company should make refunds to access service customers. USWC wants to phase the refund into rates and make no refund to access service customers.

Staff and USWC have not agreed on the refund procedures or on how to calculate the refund. If the Commission orders a refund based on the revenue requirement established in this docket, Staff recommends that USWC's Measure 5 savings for May and June 1996 be used to reduce the amount of the UT 125 refund. These savings were included in the refund USWC made to customers in January 1996.

ISSUE 11: REFUND PROCEDURES – BASIS OF REFUND

[Deleted text not readopted.]

Completely Settled Issue:

Staff and USWC agree that the refund should be reduced by the Measure 5 refund that related to May and June 1996. ($.9 million, Issue 8e, Ballot Measure 5 Property Taxes)

Disputed Adjustments *(which Staff would include but USWC would exclude):*

Staff and USWC disagree about the basis of the refund. Staff believes the refund should follow Commission Order No. 96-183. Therefore, it should be based on the total revenue requirement established in this docket,[45] except for the Ballot Measure 5 refunds for May and June 1996.

USWC argues that the refund should follow Order No. 91-1598 and be based on actual earnings. USWC agrees that some adjustments should be made to the test year before calculating the refund but three types of adjustments should generally be excluded: estimates and forecasts, imputations, and disallowances of recorded data.

Estimates and Forecasts. Many adjustments in this proceeding are based on estimated revenues and expenses that Staff expects USWC to achieve during the period when rates are in effect. USWC claims that estimates and forecasts should be ignored in a refund calculation. However, the stipulated test year includes three months of estimates, which the company would include in calculating a refund. USWC would also include the estimated effects of pending sales of exchanges on allocation factors (Issue 4f) and the estimated effects of docket UM 351. [Deleted text not readopted.]

Imputations. According to USWC, these adjustments [deleted text not readopted] remove or add imputed amounts and, therefore, should be ignored in the refund calculation. However, the company does not exclude US WEST Direct directory revenues (Issue 3a) from the refund calculation. The company agreed to the imputation of Yellow Pages revenue in Order No. 91-1598, UT 80.

Disallowances of Recorded Data. According to USWC, these adjustments [deleted text not readopted] would impose retroactive ratemaking if they are included in calculating the refund. USWC does not exclude the floor space adjustment (included in Issue 4a) from the calculation.

[45] In Order No. 96-183 at 4, the Commission concluded that “the amount subject to refund by USWC is equal to the difference between the permanent rate level established in pending docket UT 125 and the current interim level, assuming that the latter amount of revenues is greater than the former.”

Total Adjustments to Include in the Refund Calculation *(where the amounts depend on whose adjustments are adopted):* [Deleted text not readopted.] The amounts depend on whose adjustments are adopted in Issues 1 through 10 and 14.

If we order a refund in this proceeding, Staff recommends that we implement it as follows:

1. The refund should be made within 60 days after the Commission issues an order directing USWC to make a refund.

2. The refund should be made as a one time, lump sum credit on customers' bills.

3. The refund should be made to customers of USWC as of the refund date.

4. There should be no refund for toll service.

5. Interexchange carriers (IXCs) who are access service customers of USWC should receive refunds based on the immediately preceding the refund date. In the aggregate, the portion of the total refund that should be distributed to IXCs should be calculated using the ratio of USWC's Oregon intrastate access revenues to total intrastate revenues subject to refund, as determined in this proceeding.

6. The rest of the refund should be distributed to local service customers, on a per line basis, in the following ratios:

Group	Current Rate	Ratio**	
Residential	$12.80	1.00	All residential service lines
Bus. Simple	$30.87	2.40	Business simple lines and business measured lines
Bus. Complex	$34.77	2.70	Other business, switched service lines, including complex, DID trunks, ISDN, PAL, semipublic

Centrex	varies	1.00	All Centrex type lines
Private Line	$9.80 (basic)	0.75	Refund per NAC

**Each ratio is approximately equal to the ratio of the current rate for the service to the rate for the residential group.

USWC generally agrees with Staff's recommendations. However, USWC argues that no refunds should go to the IXCs because they have already received permanent rate reductions over the past four years.

Staff disagrees with USWC's position on refunds to IXCs. Staff recommends that any refund be divided among groups of customers approximately in proportion to the total revenue USWC receives from each group. The IXCs' proportionate share would reflect the rates they paid over the 12 months preceding the refund. Further, despite periodic rate adjustments for access service, the IXCs may still be paying higher rates than what the Commission ultimately determines is reasonable.

USWC contends that Order No. 91-1598 requires the consideration of "actual earnings" in determining refunds. The order discusses the refund procedures to be followed or the rates to be charged by USWC in the event the AFOR is terminated prematurely.[46] The Commission prematurely terminated USWC's AFOR by Order No. 96-107. That order provided that "U S WEST's rates for services [from May 1, 1996] shall be considered interim rates subject to refund with interest." *Id*. at 3.

USWC filed a Petition for Clarification and Request for Ruling on May 31, 1996, asking the

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[46] The order provides, at 28-29:

> Subparagraph (3) specifies that the rates in effect from the date the plan is terminated until the date new permanent rates are set shall be interim rates subject to refund. A refund will take place only where USWC is determined to have been overearning. The amount of any refund will equal the difference between the amount USWC is actually earning and the amount subsequently found to be reasonable. Any refunds will accrue interest at USWC's authorized rate of return on rate base.

Commission to clarify that any refund would be calculated using USWC's actual earnings during the interim rate period. On July 16, 1996, the Commission issued Order No. 96-183, which concluded that the amount subject to refund would be "equal to the difference between the permanent rate level established in pending docket UT 125, and the current interim level, assuming that the latter amount of revenues is greater than the former." *Id.* at 4. The Commission stated that the refund procedure would be similar to that used in ORS 757.215(4) and 759.185(4). *Id.* On September 16, 1996, USWC filed a Petition for Reconsideration, which was denied in Order No. 96-86. USWC has filed a judicial appeal of this order and of Order No. 96-183. USWC argues that the Commission erred in its application of Order No. 91-1598 by determining that the refund would not be based on what USWC is actually earning.

USWC also argues that because Staff has used forecasts in its proposed adjustments, the adjustments bring future revenues into the current time period as if they were being earned now. USWC argues that the forecasted adjustments distort the refund amount because a refund will be based on a forecast, as opposed to actual earnings as specifically contemplated in Order No. 91-1598; and because some or all of the earnings are not forecasted to occur until after the period that rates are interim, they are not subject to refund.

According to USWC, using forecasted adjustments means that the Commission has no way of knowing if earnings are ever actually achieved. The presumption of Staff's forecast adjustment is that USWC would pay ratepayers the refund now for future revenue growth or expense reduction, and over the period of rates would "earn" the refund back. USWC argues that this is inaccurate. Under Staff's approach, the refund would be paid on earnings projected to occur after rates are no longer interim and subject to refund. The Commission has no assurance that Staff's forecasts will come about. Additionally, USWC argues, ratepayers would receive interest on the refund of earnings that USWC would be presumed to achieve. This interest would never be earned back. USWC argues that this is unreasonable.

USWC also argues that imputed amounts are amounts not actually earned and that they should also be excluded from the refund calculation. Moreover, USWC contends that including disallowed recorded data in the refund calculation constitutes retroactive ratemaking.

USWC proposes that the Commission should handle any refund amounts that may be due to customers in the form of phasing in rates. If the Commission adopts its proposal, USWC argues that interest should cease to accrue as of the date of the Commission's order in this phase of the docket.

Disposition. [Deleted text not readopted.]

We reviewed each estimate and forecast that we adopted to ensure that it was reasonably certain to occur. Our reasons for adopting adjustments of this sort to the test year are discussed under Issue 1a(1) above. In brief, these reasonably certain adjustments serve to make the test year representative of the period during which rates from this docket are likely to be in effect. Moreover, we note that USWC has proposed forecasted adjustments of its own: the proposed depreciation expense adjustment and the adjustment for the future adverse effects of the orders in Commission docket UM 351.

In Issue 7e, Staff Adjustment 36, Staff removed part of an accrual that will end soon after rates in this proceeding go into effect. Staff considers this a normalizing adjustment, but USWC argues that it is an imputation. We consider this a normalizing adjustment designed to make the test year representative of the period when rates from this docket will likely be in effect. USWC also argues against the imputation involving Part 64 Still Regulated services (Issue 4g(2)). We consider it fair to order a refund of imputed revenues in this case for the same reason we consider the imputation fair. The imputation makes these services revenue requirement neutral and prevents subsidies flowing from regulated services to those that are subject to competition and underearning.

USWC contends that including disallowances of actual expenses in the refund amount constitutes retroactive ratemaking. USWC's argument is not well taken. As the Oregon Court of Appeals recently stated:

> Retroactive ratemaking occurs when past profits or losses are incorporated in setting future rates. *Pacific Northwest Bell Telephone Co. v. Katz*, 116 Or App 302, 311 (1992).

In other words, retroactive ratemaking is a way of truing up faulty projections as to earnings or expenses. That is not the case here. We are dealing here with interim rates subject to refund. We have determined that USWC's revenues should be reduced by approximately $[text deleted not adopted], on average, throughout the period when rates from this docket will be in effect. Until the rate design order in the case is entered, the refund mechanism will address the necessary revenue requirement reduction. Once the rate design order takes effect, rates will reflect that reduction. In both cases, we are making prospective reductions. We are not going back in time to capture past overearnings. USWC objects to including disallowances in the refund. Those amounts were included in the revenue requirement reduction. Once that determination was made, logically they should be included in the refund as well.

For the refund procedure, we adopt Staff's lump sum refund proposal. We believe that more of the ratepayers who contributed to USWC's overearning will receive a refund in that manner than if we phase the refund through rates. Interest on the refund will accrue until the refund is paid.

[Deleted text not readopted.]

We find it reasonable that IXCs receive a refund as well, for the reasons Staff gives. We also adopt Staff's recommendation that any refund be divided among groups of customers approximately in proportion to the total revenue USWC receives from each group.

[Deleted text not readopted.]

We adopt Staff's proposed distribution of the refund on a per line basis, set out above. If the refund amount should exceed a customer's bill in a given month, then the refund credit shall be carried forward into the next month.

Issue 14, Effect of UM 351 on Access Revenues. The discussion on page 114 of Order No. 97-171 is readopted.

ISSUE 14: EFFECT OF UM 351 ON ACCESS REVENUES

Disputed Issue:

- USWC argues that the effect of Order No. 96-188 (dated July 19, 1996, in docket UM 351) is a revenue requirement issue. Staff believes this is a rate design issue.

On November 1, 1996, the Commission issued Order No. 96-283 (UM 351), which revised certain aspects of an earlier order in that docket, Order No. 96-188. Under the revised rates in Order No. 96-283, Staff estimates that the UM 351 revenue impact on USWC is currently $1.9 million. USWC agrees with this figure.

The revision to Order No. 96-188 dropped the estimated revenue impact from $8.5 million to the current figure. The current revenue impact estimate may change further, due to new cost studies filed in compliance with Order No. 96-284 (UM 773, the cost study docket). Staff recommends that this revenue impact and any rate arbitrage issue be addressed in the rate design phase of UT 125.

Disposition. We conclude that Issue 14 is an issue appropriate to the rate design phase of this case. We have adjusted the rate design phase of this proceeding to coordinate with new costs arising from UM 773. During rate design, Staff and USWC can address the UM 773 costs and align the rates so that any arbitrage issue is eliminated. At this point, the ultimate revenue impact is unknown, so it would be premature to deal with the revenue impact issue here.

Ordering Paragraph 4f: distribution of the refund. This paragraph, at page 115 of Order No. 97-171, is readopted.

4. The revenue reduction [deleted text not readopted] shall be refunded as follows:

* * * * *

f. The remainder of the refund shall be distributed to local service customers, on a per line basis, in the following ratios:

Group	Current Rate	Ratio**	
Residential	$12.80	1.00	All residential service lines
Bus. Simple	$30.87	2.40	Business simple lines and business measured lines
Bus. Complex	$34.77	2.70	Other business, switched service lines, including complex, DID trunks, ISDN, PAL, semipublic
Centrex	varies	1.00	All Centrex type lines
Private Line	$9.80 (basic)	0.75	Refund per NAC

Made, entered, and effective ________________________.

Ron Eachus
Chairman

Roger Hamilton
Commissioner

Joan H. Smith
Commissioner

A party may request rehearing or reconsideration of this order pursuant to ORS 756.561. A request for rehearing or reconsideration must be filed with the Commission within 60 days of the date of service of this order. The request must comply with the requirements in OAR 860-014-0095. A copy of any such request must also be served on each party to the proceeding as provided by OAR 860-013-0070(2). A party may appeal this order to a court pursuant to applicable law.