BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

In the matter of the application of Northwestern Bell Telephone Company, Omaha, Nebraska, for authority to Adjust the Rates and Charges for Telephone Service Furnished by it in the State of Nebraska.	Application No. C-595 GRANTED IN PART Entered: September 16, 1986

APPEARANCES: For the applicant
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and
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For the Commission
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OPINION AND FINDINGS

BY THE COMMISSION:

By its application filed June 7, 1985, the Northwestern Bell Telephone Company, Omaha, Nebraska, seeks to adjust the rates and charges for telephone service furnished by it in the State of Nebraska.

Notice of the filing of the application was published pursuant to the provisions of the Commission's rules and regulations. Several hundred letters of protest to the application were received.

Pursuant to notice required by law, public hearing was held on the application on July 8, 9, and 10, 1986 in the Board of Equalization Room, City/County Building, Omaha, Nebraska with appearances as set forth above.

Additional public hearings were held in Grand Island, Nebraska on July 11th; O'Neill, Nebraska on July 16th; and North Platte, Nebraska on July 17, 1986.

Upon consideration of the application, the evidence adduced at the hearings and being fully advised, the Commission is of the opinion and finds that:

GENERAL

1. The applicant is a corporation existing under the laws of the State of Iowa with its general operating headquarters at Omaha, Nebraska. It is a common carrier furnishing general communications services in Nebraska, Iowa, Minnesota, North Dakota and South Dakota, and is under the jurisdiction of this Commission.

2. Applicant furnishes local and long distance service at 95 telephone exchanges in Nebraska serving approximately 428,202 access lines and provides long distance connections to 205 exchanges of other telephone companies in the state.

3. Applicant's current authorized return on equity was approved by the Commission in its order entered December 18, 1984 in Application No. C-484.

4. Applicant alleges that its earnings are inadequate and do not provide a fair and reasonable rate of return on its property in Nebraska devoted to intrastate business. Applicant seeks to increase rates in an amount to produce additional annual revenue of $14,500,000.

5. For the purpose of determining the results of operations, the applicant originally used a test year ending December 31, 1984 and the Commission staff used a test year ending December 31, 1985. At the time of hearing applicant updated its test year to 1985. Both applicant and staff have used an end-of-period rate base. Intrastate revenues, expenses and investments were determined in accordance with the NARUC Separations Manual.

RATE BASE

6. Applicant's exhibits reflect its adjusted rate base as of December 31, 1985 to be $360,936,274.

7. Staff's adjusted rate base as of December 31, 1985 is the sum of $369,690,489 and consists of:

Telephone plant in service	$586,040,574
Short term construction	6,146,804
Materials and supplies	9,956,848
Depreciation reserve	(153,271,685)
Deferred Taxes	(78,986,350)
Pre-1971 investment tax credits	(195,702)
	$369,690,489

Staff has included investment, revenues and expenses associated with facilities leased to AT&T in the results of operations, whereas the applicant has excluded such costs.

8. Applicant's witness Elofson testified that, using lead-lag study methods found appropriate by the Commission in prior cases, a working capital allowance of $330,000 is required.

9. We find that it is appropriate to include an allowance for working capital in the amount of $330,000 and to include the staff's adjustment for facilities leased to AT&T. The rate base to be used in this case should therefore be $370,020,489.

RESULTS OF OPERATIONS

10. Applicant's exhibits show intrastate net telephone earnings for the year 1985 adjusted for known changes in the amount of $34,484,408. Adjustments include wage increases, separations factor changes resulting from loss of revenue from billing inquiry and interstate WATS billing and other out of period or normalizing adjustments.

11. Staff's exhibits reflect intrastate net telephone earnings to be the sum of $37,984,297. A number of adjustments proposed by the staff and the company were not contested. These adjustments include the CPE phase-out, independent company directory assistance contracts, pension accrual changes, FICA tax changes, the deregulation of inside wiring, non-management wage increases and Income Protection Plan payments. Also included were anti-trust settlement costs, non-ratepayer and nonrecurring costs, short term construction, pre-1971 investment tax credits, certain Bell Communications Research projects and facilities leased to AT&T. Other adjustments were for changes in the separations procedures including billing inquiry, subscriber plant factor, closed end WATS and AT&T interstate WATS billing.

12. Northwestern Bell Corporation costs: Staff proposes to disallow the costs in total as the company had not justified the costs. Applicant presented rebuttal testimony through Daniel L. Kotinek which justified these costs. We find that these costs are appropriate for including in the results of operations.

13. Property tax changes: Company proposes an adjustment based on the 1986 taxes estimated on the value of property as of December 31, 1985. Cross-examination of the company's witness revealed that the unit value for 1986 has not been finally determined, nor have the tax levies been determined. We find that these expenses are not known and measurable and are therefore not appropriate for inclusion in this proceeding.

14. Income tax adjustments: U.S. West Direct has filed a combined Nebraska income tax return for 1985 and has amended the 1984 return to reflect a combined return. The 1984 impact is excluded by the staff as an out of period adjustment. The 1985 impact remains in staff proposal and the staff contends that the benefit of the combined filing should be shared by Northwestern Bell. The company's position is that at the time when subsidiaries are profitable the ratepayer will be charged with more tax than should be borne by the ratepayer. The Commission has previously held that taxes for rate making purposes should reflect the actual consolidated tax filing. We find that the staff proposal recognizing the 1985 consolidated tax filing is appropriate.

15. 1985 incentive payment adjustment: During 1984 the company booked incentive payments and deducted them for tax purposes in 1985. In 1985 the company booked the incentive payments and also deducted them for tax purposes.

This change resulted in a doubling up of the tax impact in the 1985 test period. Company contends that the 1984 tax impact should be normalized out of the test year and staff contends that since the company will realize the benefit in the 1985 return it should be reflected in the 1985 test year for ratemaking purposes. We find that the 1984 booked incentive payment should be removed from the operating results as a normalizing adjustment.

16. Employee level adjustment: Company proposes an adjustment to reduce operating expenses due to a change in employee levels from that reflected in the 1985 test year. We find that this adjustment is known and measurable and should be allowed.

17. Management compensation adjustment: Company proposes to increase operating expenses based on a study of management compensation by Hewitt Associates. Cross examination of the company's witness revealed that the company did not implement all of the recommendations in the study, but rather only made adjustments where increases in salaries were recommended and made none of the recommended reductions in salaries. The company was directed to file a late-filed exhibit which included the proposed reductions and increases by position recommended by the study. The company has failed to supply this information. We find that the evidence is insufficient to determine the ultimate effect of implementation of this study in its entirety on the operating results and therefore the adjustment should be disallowed as not known and measurable.

18. Non-management wage increases: Company has filed a late-filed exhibit to reflect the cost of a new wage agreement in August of 1986 to be a decrease in net telephone earnings of $177,464. This is now a known and measurable change which will be considered in this proceeding.

19. Directory advertising adjustment: The company transferred its directory advertising operations to U.S. West Direct, a wholly owned subsidiary of NWB's parent, in 1984. Under the terms of the agreement with U.S. West Direct, NWB received net operating revenues from directory advertising of $7,441,650 in 1984 and $6,405,143 in 1985. Actual earned revenues for directory advertising in 1983 for NWB were $9,072,099. None of the company's rebuttal witnesses could testify that competetitive bids were ever considered by NWB when the determination was made to divest the directory operations; rather this decision appears to have been made at the direction of the management of NWB's parent company. It appears that the contract negotiated was not an arm's length transaction. From the evidence obtained at the hearing, this transaction does not appear to have been accomplished in a free market environment. The company transferred numerous valuable assets to U.S. West Direct in the process, but has failed to receive adequate compensation under the agreement, considering the amount of revenues it was earning from its directory operations before the transfer. The Commission finds that the company failed to negotiate the terms of this agreement to adequately protect the interests of the rate payers in the revenues generated by the directory advertising business. It also finds that the transaction was not competitive in nature and not done on an arm's length basis.

20. Evidence presented by the staff showed that NWB's revenues from directory advertising had continued to increase from 1981 through 1983, although at a reduced rate of growth from prior years. In 1984 and 1985 there were substantial reductions in directory revenues due to the "negotiated" agreement with

U.S. West Direct. The company's witness, Thomas Buch, suggested that competition in the directory advertising field was behind the decline in revenues. This may be partially true for the years prior to 1984, since the staff's evidence shows that other telephone companies suffered a decline in the growth rate of their directory operating revenues over the same period. However, the decline in growth for these companies was not as severe as the decline experienced by NWB. Their actual revenues, like NWB's revenues, continued to increase but at a declining growth rate. The companies examined were the following: Lincoln Telephone Company, United Telephone Company, and General Telephone Company, all of which engaged in directory advertising; all of which were subject to competitive pressures equal to or greater than those experienced by NWB in the same time period. Mr. Buch indicated that in the face of rising competition in 1983 and in an attempt to increase its overall level of revenues, NWB increased the advertising rates it was charging for yellow pages advertising. It was apparent on cross-examination of Mr. Buch, that NWB would not have incurred the actual reductions in revenues experienced as a direct result of the contract with U.S. West Direct, if NWB's directory advertising business had not been transferred to U.S. West Direct. In consideration of the testimony and evidence, the Commission finds that the actual decrease in directory revenues suffered by NWB was a direct result of the contract it entered into with U.S. West Direct; said contract was not competitively bid and was not negotiated at arm's length. The Commission further notes that although competition may have caused a reduced growth rate in revenues from directory advertising, in all probability, based on the evidence presented to the Commission, these revenues would have continued to increase during the periods 1984 and 1985 from the 1983 level, as they had previously done. The company has presented no evidence to dispute this finding.

21. The staff recommended an adjustment to the company's operating results which would impute directory advertising revenues to the company at a higher level than those actually received as a result of its agreement with U.S. West Direct. The purpose of imputing revenues would be to protect the ratepayers, by disregarding the failure of NWB to negotiate an appropriate agreement with U.S. West Direct. The Commission finds that based on the evidence presented, net revenues would be greater than those received from the contract, if NWB had continued its directory operations, or alternately had negotiated a competitive agreement for its directory advertising business. We find that such an adjustment is appropriate in order to protect the interests of the ratepayers in the face of the inter-company dealings involved herein. There is no evidence or indication that revenues would have declined to the extent actually experienced under the contract.

22. The only question remaining is what method should be used to impute these revenues. The staff recommended two options. Option I assumes that NWB had a growth rate of 4 percent from 1983 through 1984 and from 1984 through 1985. This is the growth rate NWB achieved from 1982 through 1983.

23. Option II would assume that NWB experienced a growth rate which was the average for the other three large telephone companies in Nebraska--Lincoln, United and General. Using this option, NWB's net revenues would have grown by 8.89 percent in 1984 and by 6.46 percent in 1985. The staff recommended the more conservative approach contained in the first option.

24. A third option is also readily apparent from the data presented by the staff, and that is simply to impute the same level of actual net revenues earned in 1983.

25. It remains for us to determine the reasonableness of the proposed three options. In order to facilitate a decision of which option is apt to yield the most reasonable estimate, a model which analyzes the information contained in the record by using a 2x3 matrix that analyzes how net revenues are affected by changes in expenses and revenues per access line can be used. This model can aid the Commission in estimating what net revenues would have been in 1985 if the directory advertising operation had not been transferred to U.S. West Direct. It implicitly assumes that net revenues fall within a relevant range where fixed and variable costs per access line will not deviate far from the 1983 levels. The matrix shows the results of six different scenarios. Three different levels of growth in expense per access line since 1983 were used: 1%, 2%, and 5%. These estimates for growth in expenses test the company's assertion that increasing expenses would have extremely deleterious effects on net revenues.

26. Two different levels of growth in revenues per access line since 1983 were examined: 0% and -2%. Since NWB's rebuttal witnesses testified that the historical trend showed a decreasing growth in revenues, a 0% or -2% growth estimate would be conservative even by NWB's own estimates. Mr. Buch testified that competition would probably depress prices for directory advertising. However, revenues are a function of both price and volume. Mr. Burvainis, PSC Staff Accountant, testified that business access lines have increased since 1983. Even if the price per access line had remained stable or had decreased, total revenues still would be growing.

PROJECTED INTRASTATE NET REVENUES

GROWTH IN	5%	$10,826,724	$10,158,185
EXPENSES PER	2%	11,167,813	10,499,274
ACCESS LINE	0%	11,389,713	10,721,174
		0%	-2%

27. The six separate cases analyzed revealed that each intrastate net revenue result would surpass staff's Option 1 recommendation for a before-tax adjustment of $3,547,395. This is based on a $10,032,939 net revenue figure.

28. Mr. Quinn, one of the company's rebuttal witnesses, testified that the statistical principles involved in the staff's recommended approach were invalid. The Commission, however, is cognizant that statistical analyses may take many forms and often reach very different results. In the present case, for example, the company focused only on the declining growth rate for directory revenues during the period prior to the transfer of the directory business to U.S. West Direct. It was apparent on cross examination of this witness that even if one properly projected the declining growth rate in revenues according to the company's rebuttal methodology, the results would not have been as severe as the actual decreases in revenue experienced by the company due to its

contract with U.S. West Direct. Moreover, the Company chose to ignore the continued growth in actual revenue prior to the agreement with U.S. West Direct.

29. The question of imputing revenues under these circumstances is obviously not one which lends itself to scientific precision. The test therefore ought to be one of reasonableness. The rebuttal testimony, although highly critical of the staff's recommended methodology, did not demonstrate that the result achieved was unreasonableness. Moreover, the company presented no testimony sponsoring what would, in their opinion, be a reasonable approach. Clearly, the use of the actual revenues received from U.S. West Direct, in the face of the evidence presented by the staff, and the fact that this agreement was not an arm's length transaction, dictates that these results are not reasonable for ratemaking under these circumstances. The company's witnesses also suggested that any approach should include various expenses associated with directory revenues, but never presented any evidence as to what these expenses should actually be under any methodology.

30. It is the Commission's opinion, based on the evidence presented by the staff, and the failure of NWB to present any meaningful evidence in this regard, that all three methods achieve reasonable results with Option III providing a minimum adjustment. We find that net revenues should be imputed to NWB for the purposes of ratemaking using Option I, and that an adjustment to the company's operating results in the amount of $3,547,395 is appropriate for this proceeding.

31. We find that, based on the adjustments set forth above, applicant's net telephone earnings for the 1985 test year were $38,890,086.

DEPRECIATION

32. In its May 27, 1986 decision in Louisiana Public Service Commission v. Federal Communications Commission, the U.S. Supreme Court found that states have the responsibility for determining methods of depreciating dual jurisdiction property for intrastate ratemaking purposes.

33. This Commission, in a separate docket, C-664, has initiated an investigation into appropriate depreciation rates for all telephone companies.

34. While this Commission has not approved depreciation rates for intrastate property for Northwestern Bell, we find that there is not sufficient evidence to make any adjustment to depreciation expense or reserve at this time.

35. Docket C-644 is the appropriate forum to consider depreciation rates for Northwestern Bell on a going-forward basis.

RATE OF RETURN

36. Applicant presented no direct evidence on rate of return but sought to be allowed to continue the rate of return previously granted.

37. Staff witness, Bobette Murtaugh, recommended a 13.79% return on equity. Her recommendation for an overall rate of return was 11.35%. This was based on

the above recommended cost of equity, a cost of debt of 8.22% and a cost of short term debt of 7.5%. Mrs. Murtaugh used the actual capital structure of the company as of March 31, 1986. As of that date, equity was 56.61%, long term debt was 39.68%, the current portion of long term debt was .23% and short term debt was 3.48% of the total capital.

38. Mrs. Murtaugh employed two models in determining her recommended cost of equity, the Discounted Cashflow Model and the Capital Asset Pricing Model. The DCF calculation was based on a growth rate of 7.13% and a flotation factor of 3.0%. Using these factors, the current cost of equity is 13.79%. The CAPM was used as a backup method, yielding a cost of equity of 13.38%. Mrs. Murtaugh testified that, for low beta stocks such as U.S. West Direct, the CAPM tends to underestimate the cost of equity. She placed more confidence in the DCF method and recommended that 13.79% be used as the cost of equity for Northwestern Bell.

39. J. Clay Singleton testified on behalf of applicant as a rebuttal witness concerning the cost of equity capital. His cost of equity recommendation was based on two models, the Discounted Cashflow Model and the Generalized Risk Premium Model. The DCF calculation was based on a flotation factor of 2.4% and a growth rate of 7.1% with a standard deviation of 1.05%. This model resulted in a cost of equity range of 12.47-14.66%. The Generalized Risk Model was also used. A risk premium of 7.1% with a standard deviation of 2.4% was added to the current cost of Northwestern Bell's outstanding bonds. This resulted in a cost of equity range of 14.1-18.1%. Dr. Singleton's cost of equity recommendation is 14.38% which is the midpoint of the overlap of these two models.

40. Having considered all of the evidence, we find that the appropriate cost of equity is 13.79%, resulting in an overall rate of return of 11.35%.

SERVICE

41. Testimony was presented by Commission Engineer M. G. Hand on the results of central office service tests conducted in 21 of the applicant's exchanges. The percentage of test calls that completed properly from the selected central offices met the staff objectives in all categories except the EAS objective for Spalding.

42. Information provided by the company revealed that, for the least six months of 1985, Cody and Farwell failed to meet the Commission objective regarding trouble reports. The company should file quarterly trouble report indices for these exchanges until January 1, 1988 or further order of the Commission. The company should investigate the cause of trouble in these exchanges and file a report of their findings including plans to reduce the number of trouble reports to comply with the Commission objective.

43. The company should develop procedures for isolating toll trouble when a call is held for tracing. The procedure should apply to both interLATA and intraLATA calls and the information shared with all local exchange carriers in the state. A copy of the procedure should be filed with the Commission.

REVENUE REQUIREMENT AND RATE DESIGN

44. Mr. Hand proposed that the four present rate groups be reduced to two with the first group to include all exchanges where measured service is available.

45. The staff proposed that EAS be unbundled from the access line rate on the subscriber's bill. The rate should be developed based on the cost of each EAS network and designed so that each exchange in the network equally contributed to the revenue requirement.

46. Mr. Hand testified that technology has developed to the point where every access line should be equipped with touch tone capability at no additional charge. As of May 1986, approximately 65% of applicant's access lines were paying a touch tone charge. Applicant has fully equipped its central offices to offer touch tone service to all subscribers without additional equipment investment. The monthly cost of providing touch tone service is $.07 per residence line and $.12 per business line.

47. Applicant shall file tariffs which incorporate the staff proposals concerning rate grouping, an EAS additive and discontinuing the additional monthly charge for touch tone service.

48. Net telephone earnings of $38,890,086 produces a rate of return of 10.51% on a rate base of $370,020,489.

49. An increase in revenue of $6,158,675 is required to produce a return of 11.35%. The application should be granted in part and applicant should file for approval a schedule of rates designed to produce additional annual revenue of $6,158,675 and a plan of refund.

ORDER

IT IS THEREFORE ORDERED by the Nebraska Public Service Commission that Application No. C-595 be and it is hereby granted in part and the Northwestern Bell Telephone Company be and it is hereby authorized to increase its rates and charges to produce additional annual revenue of $6,158,675.

IT IS FURTHER ORDERED that applicant submit for approval tariffs and a plan of refund as set forth in the Opinion and Findings.

MADE AND ENTERED at Lincoln, Nebraska, this 16th day of September, 1986.

NEBRASKA PUBLIC SERVICE COMMISSION

Bob Brayton

Chairman

ATTEST:

Donald Adams

Executive Secretary

COMMISSIONER'S CONCURRING:

Duane D. Gay

//s//Bob Brayton
//s//Duane D. Gay
//s//James F. Munnelly
//s//Eric Rasmussen
//s//Harold D. Simpson