Service Date: July 30, 1987

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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IN THE MATTER of the Application of the MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY (MOUNTAIN BELL) for Authority to Establish Rates and for Approval of Generic Cost and Rate Design Methodology in Connection with the Implementation of its Comprehensive Rural Telephone Improvement Program RTIP.	UTILITY DIVISION DOCKET NO. 86.11.64 INTERIM ORDER NO.5279
IN THE MATTER of the Montana Public Service Commission's Investigation of Federal Tax Reform Impacts On Public Utility Revenue Requirements	DOCKET NO.86.11.62(11)

BACKGROUND

At the request of Mountain Bell a Protective Order was issued in this Docket. Pursuant to paragraph 5 of that order, the proprietary portions of this order are sealed and only available to Counsel of record who have signed Exhibit "A" agreeing to the terms of the Protective Order. The unsealed Order reveals no proprietary information. This information is referred to generally and referenced to the sealed order.

On November 24, 1986, the Montana Public Service Commission (Commission), initiated this Docket with an Order to Show Cause that existing rates for public utilities remain just and reasonable following the Tax Reform Act of 1986 (TRA). Filings made pursuant to the Order included information found in and reconcilable with the Commission's minimum filing requirements. On November 25, 1986, Mountain Bell filed it's application to establish rates to implement the 1986 final phase of the Rural Telephone Improvement Program (RTIP). At the request of the Montana Consumer Counsel these Dockets were consolidated and a hearing is scheduled. A Procedural Order was issued May 5, 1987.

On May 1, 1987, Mountain States Telephone and Telegraph, Inc. (Mountain Bell or Company) filed an updated revenue requirement calculation based on a 1986 test year to comply with the Commission's Show Cause Order in this Docket. This filing included the use of a 40% federal income tax rate.

On June 8, 1987, the Commission issued Order No. 5236c in Docket No. 86.11.62. That Order set forth the Commission's decisions regarding general methodology for the ratemaking impacts to reflect the changes to revenue requirements occasioned by the TRA. Various parties filed Motions for Reconsideration of that Order. On July 1, 1987, the Commission issues Order No. 5236d on Reconsideration.

On June 26, 1987, Mountain Bell filed responses to data requests from the Commission dated June 8, 1987. These data requests asked for quantifications of the general direction on TRA issues set forth in Order 5236c.

Mountain Bell's last general rate case was Docket No. 84.4.19. This Docket was based on a 1984 test year. The Cost of Capital portion of the final order in the Docket was issued on

January 31, 1985. The final order considering all other issues was Order No. 5046f issued on August 23, 1985.

In considering whether the rates of Mountain Bell continue to be reasonable in light of changes required by the TRA the Commission must look at the assumptions and calculations upon which the TRA changes were based. This Interim Order reflects the Commission's decisions regarding Mountain Bell's current revenue levels.

FINDINGS OF FACT

Rate of Return

The currently authorized overall rate of return for Mountain Bell is 11.64% as follows:

Debt	50%	9.28%	4.64%
Equity	50%	14.00%	7.00%

Total			11.64%
			======

This rate of return was established in Order No. 5046d in Docket No. 84.4.19 which was issued in January of 1985. The rate of return set in Order No. 5046d was based on testimony filed by Mountain Bell and Montana Consumer Counsel in 1984. The present capital markets are much different than those that existed in 1984. Capital costs have fallen substantially. For example, the yield on Treasury bonds was above 13% during mid 1984. These bonds are presently yielding about 30% less than during 1984.

The Commission has taken these more recent capital markets into account in setting the authorized rate of return for many Montana utilities. For instance, in Order No. 5128 in Docket No. 84.7.38 issued on April 26, 1985, the Commission granted Pacific Power and Light (PP&L) a 14.00% return on equity. Order No. 5169a in Docket No. 85.10.41 issued July 10, 1986, lowered PP&L's authorized return on equity to 12.3%. This rate of return was accepted in a stipulation in Docket No. 86.12.76.

When Mountain Bell's return on equity was reviewed in Docket No. 84.4.19 it was found to be generally comparable to the returns granted other utility companies operating in Montana. It must be noted that the Commission did allow a richer equity ratio for Mountain Bell because the Company was deemed to be somewhat more risky than electric utilities with operations in Montana. However, the Commission is concerned that Mountain Bell's rate of return is now out of line with current capital markets. For interim purposes the Commission finds that a return on equity of 13% is appropriate. An equity return of 13% is still higher than any recent return on equity granted by this Commission for electric, gas or local exchange telephone companies. However, this return provides moderate recognition that the capital markets have improved since 1984 while not prejudging the issue.

The treatment afforded Mountain Bell's interim return on equity in this order differs from the approach the PSC has used in determining interim returns on equity for the past several years. The PSC usually accepts the return on equity approved in the utility's most recent final order. The PSC finds, however, that a long period has elapsed since Mountain Bell's last authorized return was set, and during that more than two year period capital costs appear to have fallen substantially. This has been affirmed in our own orders as was explained with PP&L. To ignore these factors would be incorrect.

Although the PSC intends, for most cases, to adhere to the standard of using the most recently determined return on equity for the affected utility, extenuating circumstances may cause the Commission to deviate from this standard and moderately reflect changing circumstances in interim orders.

The Commission finds that reducing Mountain Bell's return on equity from 14% to 13% is a moderate reduction but achieves a reasonable interim balance. The lower end of the range of reasonableness may logically be indicated by the reduction of PP&L's return on equity by 1.7% which would set Mountain Bell's return on equity at 12.3%. The Commission believes a more moderate reduction to 13% will achieve a balance without prejudging the issue.

The Commission finds that Mountain Bell's overall rate of return is 10.94% as follows:

Debt	50%	8.88%	4.44%
Equity	50%	13.00%	6.50%

			10.94%
			======

Lawsuit Settlements

The Company proposed an adjustment to include cash payments for settlements related to predivestiture antitrust lawsuits in its 1986 test year . The Commission disallowed all antitrust settlements in the last Mountain Bell proceeding (Docket No. 84.4.19, Order No. 5046f, FOF 34c). The Commission still agrees with the rationale it applied to this issue in the last proceeding. Therefore, the Commission finds it proper to reject Mountain Bell's proposal for interim purposes.

Abandoned Projects

Mountain Bell included an adjustment to reflect abandoned project costs in the test year. The Commission has consistently rejected proposals to include abandoned project costs because these costs do not provide service to either current or future ratepayers. The Company's proposal to include abandoned project costs is disallowed, resulting in a $9,000 decrease in the pro forma level of expenses.

BCR Expenses

The Commission disallowed $223,000 of Bell Communication's Research (BCR) costs that were associated with development of new services and research in the last Mountain Bell general rate proceeding (Docket No. 84.4.19, Order No. 5046f, FOF 41-44). That disallowance was based on 1984 data when Mountain Bell's per books BCR expenses totaled $1,861,000. During 1986 the Company's BCR expenses exceeded $1,967,000 (Response to MCC Data Request No. 2, Set No. 6). Given the fact that total BCR expenses have not decreased, the Commission finds it reasonable to assume that new services and research expenses represent at least the same level as in the prior proceeding. Therefore, the Commission finds a $223,000 decrease for BCR expenses to be proper for interim purposes.

Pension Expense

The level of pension expense filed by Mountain Bell was calculated under FAS 87. It was adjusted to show the level of pension expense to be booked during 1987. That level, on an intrastate basis, was $86,000. On July 15, 1987, the Commission received testimony from Mountain Bell about its pension expense. That testimony also updated the level of pension expense to be booked by the Company. The update showed that Mountain Bell will actually book negative pension expense during 1987 (Testimony of Brian Johnson, p. 9).

The Commission has not yet determined the applicability of FAS 87 for ratemaking purposes and hesitates to use a level of pension expense that has been determined under this methodology until the issue has been thoroughly explored. For that reason the Commission cannot set the level of pension expense according to the Company's FAS 87 methodology.

However, included in Mr. Johnson's update was the following statement:

> Due to the current surplus of fund assets relative to the projected benefit obligation, <u>there will be no funding of the Pen sion fund in 1987</u> (Testimony of Brian Johnson, p. 9, emphasis added).

The Commission finds it reasonable for interim purposes to match the level of pension expense to be payed by ratepayers with the amount Mountain Bell will actually fund. Therefore, the Commission finds that for the purposes of this interim order Mountain Bell's pension expense is $0. This results in an $86,000 decrease in the Company's expense.

<u>Post Retirement Medical & Dental</u>

The Company proposed a $2,014,000 increase in expenses to fund post retirement medical and dental benefits for current employees. This adjustment was calculated in accordance with FAS 87. The Commission has not yet determined the applicability of FAS 87 for ratemaking purposes. Therefore, this adjustment, which deals specifically with requirements of FAS 87, will not be accepted for interim purposes.

<u>ERE Amortization</u>

Mountain Bell proposed a $106,000 adjustment to amortize the Early Retirement Enhancement Program expenses over a fifteen year period. In the last Mountain Bell general rate proceeding the Commission disallowed all costs associated with early retirement programs. Consistent application of the rationale applied in the previous proceeding dictates that this proposed adjustment must be rejected for interim purposes.

Advertising

Mountain Bell eliminated corporate advertising. This left the following categories of advertising to be recovered by ratepayers: informational, business sales, residence sales, business long distance, residence long distance, and public. Montana statutes require that most advertising be excluded for ratemaking purposes. In Order No. 5046f the Commission considered Mountain Bell's advertising expenses. The Commission only allowed informational and equal access advertising. It appears that in this case Mountain Bell included its equal access (presubscription) advertising in the informational category. Consistent with the last order the Commission finds that only advertising in the informational category should be picked up by ratepayers. This disallowance of advertising decreases Mountain Bell's allowable expenses by $407,000.

Riser Cable

Mountain Bell included an adjustment to amortize the remaining balance in account 242 (riser cable and CPR) over three years beginning January 1, 1987. In Order No. 5046f the Commission granted Mountain Bell's request to amortize inside wire in account 232 over a three year period. It may be that a similar amortization period would be appropriate for riser cable and CPR. However, this is not an appropriate adjustment for an interim order. The Commission wishes to offer parties the opportunity to comment on Mountain Bell's proposal before considering it. The removal of this adjustment from Mountain Bell's calculations decreases expenses by $328,000 and increases rate base by $102,000.

Deregulated Services

The 1985 Montana Telecommunications Act, Sections 69-3-801 et seq, MCA (MTA) defined regulated telecommunications services and specifically exempted some services from regulation. Several of the services offered by Mountain Bell are now exempted from regulated under the MTA. Section 6 of the MTA states that:

> No provider of regulated telecommunications service may use current revenues earned or expenses incurred in conjunction with services subject to regulation under this chapter to subsidize services which are not regulated...

The Administrative Rules of Montana (ARM 38.5.2709) require that a fully allocated cost accounting system be implemented by each telecommunications provider to separate the costs that are regulated by the Commission.

Mountain Bell used its Accounting Separations Plan to separate its regulated financial results from those that are not regulated. The Commission agrees that deregulated services should be removed to insure that the ratepayers are not subsiding Mountain Bell's other services. The Commission recognizes that the methods used to separate out regulated operations will be an important and contested issue in this proceeding. The Commission does not have before it enough information to correctly separate regulated and deregulated services at this time. The Commission expects that this issue will be thoroughly reviewed during the remainder of this proceeding. At the conclusion of that review the Commission will render an informed decision as to the amount of revenues, expenses, and ratebase that are wholly attributable to deregulated services.

Therefore, for purposes of this interim order the Commission will not consider this issue. Adjustments relating to the removal of services that are not regulated have been removed from calculations for the interim revenue requirement in this Order. The removal of these items represent approximately 2% of the Mountain Bell's total required net operating income.

Depreciation Update

Mountain Bell requested that the Commission set rates to reflect a 1987 depreciation technical update and a three year amortization of the reserve deficiency calculated related to that filing. The Federal Communications Commission has not yet ruled on the appropriateness of the technical update and it has not been subject to comment by any party in this proceeding. The Commission has not allowed Mountain Bell to amortize reserve deficiencies in the past. The Commission finds that this adjustment is inconsistent with past Commission practices and is not appropriate for an interim order. Removal of this adjustment results in a decrease in expenses of $3,900,000 and an increase in rate base of $1,242,000.

Directory Publishing Fee

Mountain Bell adjusts the revenue from US West Direct for publishing Mountain Bell directories to 1987 levels. In Order No. 5046f the Commission stated that:

> The Commission is very concerned that by transferring directory operations to US West Direct Mountain Bell may be attempting to siphon off the profits of the directory business. There is certainly not the comfort of an arms-length transaction when the directory contract is between two wholly owned subsidiaries of US West. For purposes of this case the Commission finds that the assump tion Ms. Bright makes that the contribution from directory operations should not be less under the new arrangement than it would have been if Mountain Bell had not transferred the directory operations. . .

Mountain Bell is now stating that the amount of revenues from US West is decreasing substantially. The Commission continues to be very concerned about the transactions between Mountain Bell and US West. For the purposes of this Order the

Commission will adjust the level of revenues back to the 1986 levels. The Commission is concerned that even the 1986 levels may not be adequate. The last year the Commission reviewed the directory publishing arrangement was for a 1984 test year and at that time increased the net revenues from the directory operations. To the extent that US West Direct has reduced payment to Mountain Bell since 1984 even the 1986 levels may be inadequate.

Tax Reform Act Impacts

On June 8, 1987, the Commission issued Order No. 5236c in the generic portion of Docket No. 86.11.62. That Order set forth the Commission decisions regarding aspects of the TRA. On June 26, 1987, Mountain Bell filed data request responses which calculated the impacts its filing of Order No. 5236c. The responses recalculated aspects of Mountain Bell's filing at a 34% tax rate. The TRA impacts decrease the revenue requirement by $4,847,000. The change to 34% also necessitates the recalculation of the multiplier used to convert the net earnings requirement of the Company to a revenue requirement. This calculation is set forth on Schedule 2.

1987 Changes

The Commission has not excluded 1987 Pro Forma adjustments for purposes of this interim order. Although these adjustments would typically be excluded for interim purposes, the Commission finds that inclusion of these items is consistent with the updated rate of return and tax act changes that occurred in 1987.

Interest Synchronization

Based on its pro forma ratebase, capital structure, and cost of debt, Mountain Bell proposed an interest synchronization adjustment that would increase the per books level of income taxes by $1,054,000. MBT's proposal left out two important factors. The first is Job Development Investment Credits (JDIC). The Commission has consistently found that JDIC must be included in the interest synchronization adjustment. The other point that needs addressing is the fact that the Company's proposal did not reflect the RTIP ratebase. These assets must be included in the adjustment at the RTIP rate of return.

With the above changes in mind, and using the accepted ratebase, capital structure, and cost of debt, the Commission finds a $2,209,000 decrease to the Company's pro forma income tax expense to be proper for interim purposes.

<u>Revenue Requirement</u>

The Commission finds that Mountain Bell has a revenue requirement of $7,273,000 as follows:

Average Rate Base	$188,775	
Overall Rate of Return	10.94%	
Required Return	20,652	
Adjusted NOI - Sch. 1 (Sealed)	27,165	
		NOI
Deficiency	(6,513)	
Income to Revenue Multiplier	1.6682	
Revenue Deficiency	(10,864)	
Expensed Asset Reim.	(22)	
Exempt Materials Adj.	(15)	
AT&T Technologies	(13)	
RTIP Incentive Earnings	8,488	
Tax Reform Act	(4,847)	
Revenue Requirement	($7,273)	

<u>RATE DESIGN</u>

The most recent orders addressing Mountain Bell's rate design have been Order 5055g in Docket No. 84.4.15, and Order No. 5173 in Docket No. 85.5.17. In Order No. 5173 the Commission found that Message Toll Service (MTS) and Wide Area Toll Service (WATS) prices should be excluded from any price increases and that the evidence presented over the past several years indicates that these prices should be reduced. (FOF 21) The Commission also found that single party business lines in larger communities

(1FB-2) should not be increased further and should probably be reduced. (FOF 22-24) In Order No. 5055g the Commission noted that the carrier access traffic sensitive elements were above both incremental costs and embedded costs. The Commission found that traffic sensitive rates should reflect incremental costs and, to the extent necessary some market related mark-up. (FOF 18-24). These areas probably are the areas where decreases in prices are justified.

On July 1, 1987 Mountain Bell implemented tariffs in compliance with the Commission's Order No. 5055g in Docket No. 84.4.15. These compliance tariffs decreased carrier access charges by $2,329,227. The compliance filing also recognized reduced settlement costs from Mountain Bell to the independent telephone companies of $504,754. This resulted in an amount to be recovered of $1,824,473. Order No. 5055g Finding of Fact No. 67 required this amount to be recovered from "across the board" increases to most basic exchange services (excluding the 1FB-2 discussed above). This would have resulted in a 2.94% increase to those services. Mountain Bell did not implement the increase at that time but requested that the amount be recovered in this Docket. Therefore, Mountain Bell needs only reduce rates by $5,448,527 in compliance with this Order.

The Commission finds that the three areas identified above, MTS, WATS and 1FB-2, should be subject to uniform percentage rate decreases to recover the revenue decrease required in this order.

OTHER MATTERS

The Commission is aware that the State of Montana has prepared and submitted a proposal to US West suggesting that Bozeman, Montana be selected for the location of US West Advanced Technologies, a research center. If Montana is chosen, the Commission would encourage Mountain Bell to communicate to the Commission the nature of telecommunications services that will be required by the installation. The Commission will expedite its consideration of those services in an effort to enhance the economic attractiveness of the State of Montana as the chosen location.

The Commission is also aware that discussion between the Commission Staff, Montana Consumer Counsel, and Mountain Bell have recently begun concerning alternative regulatory ap proaches and investment programs. The Commission directs staff to continue these discussions in a cooperative effort to consider the feasibility of alternative approaches to rate of return regulation that benefit the ratepayer and the utility.

CONCLUSIONS OF LAW

1. Mountain Bell offers regulated telecommunications services in the state of Montana and is a public utility under Section 69-3-101, MCA. The Commission has authority to supervise, regulate and control public utilities. Section 69-3-102, MCA.

2. The Commission may regulate the mode and manner of all investigations and hearings of public utilities. Section 69-3-103, MCA. The Commission may inquire into the management of the business of all public utilities, shall keep itself informed as

to the manner and method in which the same is conducted, and shall have the right to obtain from any public utility all necessary information to enable the Commission to perform its duties. Section 69-3-106, MCA.

3. Public utilities are required to render their services at just and reasonable rates. Section 69-3-110, MCA. The Commission has a duty to enforce Montana's public utility laws, and may institute an investigation of the rates, tolls, charges, rules, practices and services of a public utility. Sections 69-3-110 and 324, MCA.

4. Section 69-3-304, MCA, provides in part, "the Commission may, in its discretion, temporarily approve increases or decreases pending a hearing and final decision." The rates approved herein are a reasonable means of providing interim annual revenue reductions for Mountain Bell.

5. The Commission finds that the Company's filing in this Docket, as modified by this Order, complies with the Commission's Interim Rules. ARM 38.5.501 et seq.

6. A hearing has been scheduled in this matter. The Commission has received a request from Montana Consumer Counsel to amend the Procedural Order. Staff is directed to schedule a prehearing conference with interested parties to resolve this matter.

ORDER

1. Mountain Bell is hereby granted interim revenue decreases in the amount of $7,273,000 annually.

2. Rates shall be filed to reflect the revenue decrease granted. Such rates will be effective August 1, 1987.

DONE IN OPEN SESSION at Helena, Montana this 27th day of July, 1987, by a 4 - 1 vote.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

CLYDE JARVIS, Chairman

HOWARD L. ELLIS, Commissioner
Voting to Dissent

TOM MONAHAN, Commissioner

DANNY OBERG, Commissioner

JOHN B. DRISCOLL, Commissioner

ATTEST:

Ann Purcell
Commission Secretary

(SEAL)

SCHEDULE 2

MOUNTAIN BELL
INCOME TO REVENUE MULTIPLIER

Gross Revenues	100.0000
Less Uncollectibles	0.4798
Net Revenue 99.5202	
Public Utility Taxes	2.1224
Taxable Revenues	97.3978
State Income Tax @ 6.75%	6.5744
Federal Income Tax @ 34%	30.8800
NOI as a % of Gross Revenue	59.9435
Income to Revenue Multiplier	1.6682