Service Date: November 24, 1993

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

* * * * * * *

IN THE MATTER of the Application	)	
of GTE Northwest Incorporated	)	UTILITY DIVISION
for Authority to Increase Rates	)	DOCKET NO. 92.3.12
and for Approval of Tariff	)	ORDER NO. 5632d
Changes.	)	

FINAL ORDER

APPEARANCES

FOR THE APPLICANT:

S. Leigh Fulwood, Attorney, 1800 41st Street, Everett, Washington, 98201

Michael Rieley, Attorney, Luxan & Murfitt, Montana Club Building, Helena, Montana, 59601 appearing on behalf of GTE Northwest

FOR THE MONTANA CONSUMER COUNSEL:

Mary Wright, Attorney, 34 West Sixth Avenue, Helena, Montana, 59620

FOR THE COMMISSION:

Sandra Barrows, Rate Analyst
Eric N. Eck, Bureau Chief, Revenue Requirements
Will Rosquist, Rate Analyst
Tim Sweeney, Staff Attorney

BEFORE:

Bob Rowe, Vice Chairman
Nancy McCaffree, Commissioner
Danny Oberg, Commissioner

FINDINGS OF FACT

Background

1. On March 25, 1992, GTE Northwest Incorporated (Applicant, GTE-NW, Company), filed an application pursuant to ARM 38.5.2802 to increase rates on an annual basis by $450,000. The Applicant noted in the filing that the last general rate increase application was filed with the Commission in 1986. According to the Company the specific external factors that between 1986 and 1992 have caused earnings to fall behind expenses are inflation, continued investment in network upgrades and modernization and changes in allocations of investment and expense from the interstate to the intrastate jurisdiction. The Company proposed to recover the

total general rate request of $450,000 through permanent increases to Basic Network Access, Additional Directory Services and Directory Assistance Rates, and by the introduction of a Late Payment Charge (@ 1% per month).

2. Concurrent with the application, GTE-NW requested the Commission grant an interim increase of $292,356. GTE-NW asked that the interim increase be recovered through a uniform 24.27% surcharge on all business and residence network access, joint user service and public access lines.

3. The Applicant used its embedded cost of debt of 8.82% to calculate its interim revenue requirement. The Commission found this to be an appropriate methodology for GTE-NW in this Docket.

4. On April 28, 1992, the Commission issued a Notice of Application and Intervention Deadline. The deadline for intervention was on or before May 15, 1992.

5. On May 4, 1992, the Montana Consumer Counsel (MCC) filed a Petition for Intervention.

6. On May 14, 1992, InterBel Telephone Cooperative, Inc. filed a Petition for Intervention.

7. On June 5, 1992, the Commission issued a Notice of Staff Action which stated that intervention had been granted to MCC and InterBel Cooperative, Inc.

8. On June 29, 1992, the Commission issued Interim Order No. 5632 which granted the Company an interim increase of $132,891. The Commission found that the interim increase should be recovered through a uniform percentage surcharge on access rates.

9. On July 13, 1992, the Commission issued Procedural Order No. 5632a. That procedural order established procedural dates in this Docket, and set the hearing date for

10. On July 28, 1992, MCC filed a Motion to revise the Procedural Order, however the hearing date remained November 9, 1992.

11. On August 31, 1992, MCC filed an objection to GTE-NW's response to Data Request MCC-101 and made a Motion that the procedural schedule be suspended. Data Request MCC-101 requested the documentation and instructions for the Cost Allocations Table System (CATS). Due to the delay in MCC receiving data responses from GTE-NW, MCC stated that it would be impossible to file intervenor testimony on September 11, 1992, as set forth in the procedural schedule. For that reason, MCC moved that the Commission suspend the procedural schedule in this Docket until the Company responded to MCC's initial discovery.

12. On September 10, 1992, MCC filed a further objection to GTE-NW's response to Data Request MCC-101. On September 4, 1992, MCC received GTE-NW's supplementary response to that Data Request. MCC maintained that the supplementary response included only a listing of tables (input instructions) and reports (output). As a result, MCC stated that it was still impossible to determine the methods used by GTE-NW to allocate costs, and impossible to determine whether the cost allocations were appropriate.

13. On September 10, 1992, GTE-NW filed its response to MCC's objection to data response and Motion to Suspend Procedural Schedule.

GTE-NW stated that after sending Data Request MCC-101, MCC advised the Company orally that what was actually being sought was the actual CATS software. GTE-NW advised MCC, also orally, that the software was proprietary information and that it could not be provided. As of September 10th, GTE-NW stated that the Company had provided CATS documentation and instructions to MCC. It also had offered to meet with MCC and review all computations made through CATS and to perform actual computations on CATS with MCC if MCC so desired. GTE-NW had no objection to allowing MCC more time to prepare its testimony so long as GTE-NW was not prejudiced by shortened response and hearing preparation intervals.

14. On September 15, 1992, GTE-NW filed a response to MCC's further objection to the response to Data Request MCC-101. GTE-NW stated that the requested information had been provided to MCC and noted that

GTE-NW had offered to provide additional information.

15. On September 16, 1992, the Commission issued a Notice of Commission Action which stated that: at a properly noticed work session held on September 9, 1992, the Commission granted: (1) the objection of MCC to GTE-NW's response to Data Request MCC-101; and (2) MCC's Motion to suspend the procedural schedule. GTE-NW was directed to provide the documentation and instructions for the (CATS) referenced in Data Request MCC-24. MCC's request for sanctions pursuant to paragraph 14 of the procedural schedule was denied.

16. On September 18, 1992, GTE-NW filed a Motion for Reconsideration and a Brief in support of that Motion. Since GTE-NW felt that it had fully complied with Data Request MCC-101 as drafted, the Company requested that the Commission rule that it had complied with the Data Request submitted.

17. On September 22, 1992, the Commission issued Protective Order No. 5632b.

18. On September 30, 1992, the Commission issued a Notice of Commission Action in Docket No. N-92-50. The Notice stated that: at a duly noticed worksession on September 29, 1992, Smart Call Service was approved on an interim basis. The cost information and pricing proposals regarding Smart Call Service will be further examined in GTE-NW's general rate case proceeding designated Docket No. 92.3.12. The Notice indicated that the Commission's final

decision regarding Smart Call Service would be based on the outcome of Docket No. 92.3.12.

19. On October 13, 1992, the Commission issued Revised Procedural Order No. 5632c which established a new hearing date of January 20, 1993.

20. On December 29, 1992, the Commission issued a Notice of Public Satellite Hearing. That Notice indicated that the Commission would hold a hearing to take public testimony at 7:00 p.m. on January 26, 1993, in the County Annex Building, 418 Mineral Avenue, in Libby, Montana.

21. On January 13, 1993, the Commission issued a Notice of Public Hearing. The Notice indicated that the hearing in this Docket would be held at 9:00 a.m. on February 9, 1993, in the Bollinger Room at 1701 Prospect Avenue in Helena, Montana.

22. On February 4, 1993, InterBel Telephone Cooperative, Inc. requested that its petition for intervention be dismissed. InterBel explained that the reasons for its intervention had been resolved through discussions with GTE-NW.

23. On February 9, 1993, starting at 9:00 a.m. the Commission held a public hearing in this Docket.

REVENUE REQUIREMENTS

Rate of Return

Capital Structure

24. In its initial application, GTE-NW did not propose a specific capital structure. In

GTE-NW's rebuttal testimony, Mr. Jerry Austin presented the Company's proposed capital structure.

25. GTE-NW proposed the following capital structure and associated costs:

	Amount (000's)	Percent of Capital	Rate	Rate of Return
Long Term Debt	$490,764	34.594%	9.212%	3.187%
Short Term Debt	122,755	8.653	4.889	.423
Preferred Stock	7,200	.508	8.276	.042
Common Equity	797,932	56.245	13.500	7.593
Total	$1,418,651	100.00%		11.245%

26. On October 20, 1992, the MCC filed testimony and exhibits in this Docket. MCC witness Dr. John Wilson addressed capital structure at pages 7-15 of his original testimony. Dr. Wilson stated that GTE-NW's common equity capital is wholly owned by GTE Corp., whose own capital structure is comprised of debt and preferred stock (40 percent) as well as publicly held common equity (60 percent). Since both the parent company and GTE-NW issue debt, GTE-NW's common equity is "double leveraged." Therefore, in determining a fair and reasonable rate of return on rate base in this case it is important to recognize and account for the actual <u>market</u> cost of the regulated utility's common equity capital -- 40 percent of which is actually funded by the parent's debt and preferred stock issues.

27. MCC proposed the following capital structure and associated costs:

	Amount (000's)	Percent of Capital	Rate	Rate of Return
Long Term Debt	$493,350	34.71%	8.821%	3.0618%
Short Term Debt	122,755	8.64	3.847	.3324
Preferred Stock	7,200	.51	8.276	.0422
Common Equity	797,932	56.14	9.826*	5.5163

Total	$1,421,237	100.00%	8.9527%

* Based on the overall cost of capital for GTE Corp. (Parent)

28. The differences between the two parties' capital structures relate to the double leverage between GTE-NW and its parent, GTE Corp., as well as differences in the dollar amount of long-term debt.

Double Leverage Adjustment

29. Dr. Wilson noted that as of year-end 1991, GTE-NW's common equity ratio was 56.14 percent and its parent's (GTE Corp.) equity ratio was 60.39 percent. Dr. Wilson observed that those equity ratios are high for a utility company. One reason that GTE-NW has a high equity ratio is that it does not reflect the senior capital (i.e. double leverage) that GTE Corp. uses to finance its equity investment in GTE-NW's rate base. The allowed rate of return should compensate investors for their actual capital commitments, therefore, it must be recognized in ratemaking that the debt and preferred stock capital that is sold to investors by GTE Corp. is used to support GTE Corp.'s equity investment in GTE-NW.

30. GTE-NW's balance sheet contains both senior obligations held by bondholders and common equity which is owned by GTE Corp. GTE-NW's common equity capital is booked as an asset (investment in subsidiaries) on GTE Corp's balance sheet. GTE Corp's balance sheet also contains both senior obligations held by preferred shareholders and bondholders, and common equity owned by the investors who set the market price of GTE Corp's common shares. When GTE-NW earns a return on its utility rate base, both GTE-NW's interest expense and GTE Corp's interest expense and preferred dividend obligations must be paid before the common equity investors receive a return on their equity investment in GTE-NW. At page 10 of his

testimony, Dr. Wilson provided an illustration of the recognition of double leverage. He concluded that: "If double leverage is not recognized for ratemaking purposes, ratepayers will be substantially overcharged."

31. Dr. Wilson stated that the Commission should recognize that GTE-NW's common equity ratio does not actually reflect the portion of total capitalization that is truly accounted for by publicly-held common equity capital. Instead of the 56.14 percent equity ratio for GTE-NW, Dr. Wilson arrives at a percentage of 33.9 percent as follows: Since GTE Corp. funds all of GTE-NW's common stock with its own capital and since only 60.39 percent of GTE Corp's total capital is common equity, only 33.9 percent (56.14 percent GTE-NW equity times 60.39 percent GTE Corp equity) of GTE-NW's common stock is actually common equity financed. The remaining 22.24 percent (56.14 - 33.9) of GTE-NW's equity is actually debt financed. Dr. Wilson recommends calculating GTE-NW's rate of return allowance based on GTE-NW's own cost of debt for 43.35 percent of total capital, plus GTE-NW's own cost of preferred stock for 0.51 percent of total capital, plus GTE Corp's cost of debt and preferred stock for 22.24 percent of total capital, and GTE Corp's cost of common equity for 33.90 percent of total capital. This adjustment is found in Dr. Wilson's prefiled testimony beginning on line 13, page 13. It continues on through line 10 on page 15. It is also shown on page 1 of Dr. Wilson's exhibit (J.W.-1).

32. GTE-NW's rebuttal witness on capital structure and the cost of capital was Mr. Jerry L. Austin, who is the Treasurer of GTE-NW. Mr. Austin stated with respect to the issues of cost of capital, capital structure and interest synchronization presented by MCC: "Their recommendations if adopted, would have a very serious and adverse impact on the financial stability of GTE-NW in Montana."

33. Mr. Austin argued that Dr. Wilson's use of a double leveraged capital structure is

counter to economic and financial conclusions established by case law and fails to recognize risks unique to GTE-NW. Second, Dr. Wilson's imputed rate of return of 9.826 percent for the cost of common equity for GTE-NW is barely above the current yield on GTE-NW's bonds. According to Mr. Austin this rate of return would effectively decrease the Company's interest coverage to 2.25 times and jeopardize the Company's bond and commercial paper ratings, which would further reduce the Company's interest coverage.

34. Mr. Austin states that the double leverage technique is conceptually flawed because the identity of GTE-NW's shareholders should have no bearing on its cost of equity. At page 18 of his rebuttal testimony, Mr. Austin begins to list his major objections to the use of double leverage.

35. Mr. Austin concluded his rebuttal testimony by recommending that the actual capital structure of GTE-NW at December 31, 1991, shown on exhibit JLA-8R, page 1 of 4 be used in this proceeding.

36. GTE-NW argued that double leverage is a theoretical construct whose only purpose is to lower the amount of equity attributable to a utility and thereby lower its overall rate of return. GTE-NW argues that the embedded cost of debt in its rebuttal case of (9.2 percent) is higher than MCC's proposed overall rate of return.

37. According to GTE-NW, double leverage is inconsistent with the <u>Bluefield Water Works</u> case because it takes the risk of GTE-NW operating in Montana and averages it among several utility and non-utility business enterprises in GTE Corp which are located all over the world. GTE-NW stated that there is no United States Supreme Court authority discussing double leverage. GTE-NW also noted that the Montana Supreme Court upheld the use of double leverage in a Mountain States Telephone case in 1981. Finally, GTE-NW cited the case of

Associated Natural Gas Company v. Arkansas Public Service Commission where the court, after reviewing a history of mergers, acquisitions and divestitures by the parent company, many involving non-cash transfers such as those GTE Corporation has entered into over the years, found that the subsidiary was not funded in the manner assumed by double leverage.

38. GTE-NW urged the Commission to ignore the reality of its capital structure, which is that it is double leveraged. MCC's position is that a return on common equity should be provided only for capital actually supplied by stockholders.

39. GTE-NW did not dispute the fact that GTE-NW's common equity is double leveraged. GTE-NW did not dispute the accuracy of Dr. Wilson's calculations or the underlying numbers. The only issue was whether a double leverage adjustment is fundamentally appropriate.

40. An authorized rate of return in excess of the cost of capital is both an unnecessary reward to shareholders and an unnecessary cost to a utility's captive customers. Utility customers have no obligation to provide excess returns to the owners of a monopoly enterprise. If GTE Corp's debt leverage is not reflected in the rate of return allowance, as would be the case if GTE-NW's own capital structure were used in the rate setting process, ratepayers will be overcharged for utility service and common equity shareholders will be permitted to earn excess returns on their investment in utility assets.

41. MCC noted that neither the Hope Natural Gas, Bluefield nor the Duquesne Light cases specifically dealt with the issue of a double leveraged capital structure. Thus, the Supreme Court has made it clear that although certain standards must be met, states are free to determine how they should be met, and it does not follow that these three cases preclude the Commission from adopting the double leverage adjustment. The Idaho Supreme Court has upheld the adjustment, finding it to be specifically in accord with Hope. It also found that the double

leverage adjustment did not violate GTE-NW's rights to due process and equal protection and did not confiscate its property. General Telephone Company of the Northwest, Inc. v. Idaho Public Utilities Commission, 712 P. 2d 643, 646-650 (1986).

42. MCC noted that in the Mountain Bell case this Commission made a specific conclusion of law that the requirements of Hope were met:

> The Commission's "double leverage" approach in Order No. 4389d has provided Mountain Bell with a rate of return that meets the constitutional requirement of being "commensurate with the returns on investments in other enterprises having corresponding risks and sufficient to insure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 603 (1944).
> (Docket No. 6496, Order No. 4389g, Conclusion of Law 1)

43. Both the district court and the Montana Supreme Court upheld the Commission's reasoning and its conclusion on this point. To provide GTE-NW with a return based upon an estimate of risk, without focusing on the source of the capital actually invested in the company, would run counter to all sound regulatory guidelines and precedents.

Commission Decision

44. Mr. Austin argued that if GTE cannot earn a return on its investment in GTE-NW that is competitive with returns on other investments of comparable risk, it may shift its discretionary funds away from GTE-NW. The Commission is fully capable of judging the level of GTE-NW's investment of discretionary funds in Montana in recent years. Mr. Austin went on to state: "Furthermore, if subsidiaries can earn a higher return by being sold or spun off they will be." The post-hearing announcement by GTE that it intends to sell the Montana properties to Citizens Utilities indicates the accuracy of Mr. Austin's quote. In fact, GTE Corp. has decided to sell a number of telephone operations.

45. One of Mr. Austin's main arguments had some surface appeal. He stated that

double leverage is founded upon invalid assumptions concerning the financing of GTE-NW's capital structure. He then went on to give a history of the financing of GTE and noted that there had been numerous acquisitions of operating properties in exchange for securities. He also claimed that retained earnings which comprise almost 50 percent of GTE-NW's total common equity capital did not originate from the parent. Dr. Wilson correctly pointed out that the retained earnings of GTE-NW are owned and controlled by GTE Corporation. In the district court decision in the Mountain Bell case, the court adopted the reasoning of Basil L. Copeland, Jr., in his article "Double Leverage One More Time," 100 Public Utilities Fortnightly 19: "... the cost of equity is the same whether the equity was raised in the capital market or exists in the form of retained earnings. If a subsidiary retains a portion of its earnings, the earnings it retains are no less the capital of the parent than the capital recorded on its accounts as 'paid in'!"

46. GTE-NW argued that double leverage is inappropriate because it averages the risk for GTE-NW with all of the other operations of GTE Corporation. MCC pointed out that the goal of determining a rate of return for a utility is to determine the cost of capital.

47. There is ample case law which supports the use of the double leverage adjustment. GTE operates in at least two jurisdictions where the adjustment has been used; Tennessee and Idaho. This Commission has used the adjustment in a Mountain Bell case. In that case, the use of double leverage was affirmed by both the district court and the Montana Supreme Court. There was a factual difference in that Mountain Bell case. At the time the case was heard, AT&T owned 88.55 percent of the common stock of Mountain Bell with the balance being held by minority stockholders. Subsequent to that case, AT&T purchased the remaining stock which had the effect of making Mountain Bell a wholly-owned subsidiary. That is the same situation which exists between GTE Corp and GTE-NW.

48. Given the extensive case law on the issue of double leverage, GTE-NW's arguments related to lack of support for the concept in financial textbooks are not persuasive. Therefore, as in Docket No. 6496, the Commission agrees that the Double Leverage adjustment should be made.

Cost of Capital

49. In its initial filing, GTE-NW proposed a 10.45 percent overall rate of return. GTE-NW stated it would accept a return lower than its previously authorized 12 percent in order to minimize the impact of the rate increase on its customers and to utilize the expeditious procedures applicable to revenue increase requests of less than $500,000. GTE-NW did not provide a breakdown of the capital structure and costs which comprised the overall rate of return of 10.45 percent. GTE-NW proposed 8.82 percent (the long-term debt cost) as the overall rate of return for the purpose of calculating interim relief.

50. In the Company's original filing Mr. Sanchez included Exhibit SPS-1 which detailed the Company's long-term debt. That Exhibit showed long-term debt of $491,723,571 at a cost of 8.821 percent.

51. Dr. Wilson included $493,350,000 of long-term debt in his recommended capital structure. This number was taken from page 16 of GTE-NW's 1991 annual report, there are two numbers: 1) Total long-term debt of $488,106,000 and 2) maturities, installments and sinking fund requirements for 1992 of $5,244,000. Adding the two numbers provides the long-term debt amount of $493,350,000 shown on Exhibit JW-1. Dr. Wilson used a cost of long-term debt of 8.821 percent, which is the debt cost shown on Mr. Sanchez's exhibit SPS-1.

52. Mr. Austin included long-term debt in the amount of $490,764,000 at a cost of 9.212 percent. The source of that number is Rebuttal Exhibit JLA-8R, page 3 of 4.

53. The difference between the exhibits filed by Mr. Sanchez in the direct case and Mr. Austin in the rebuttal case can be seen by examining Mr. Austin's Rebuttal Exhibit JLA-8R, page 3 of 4. Lines 14, 15 and 16 are new lines which do not appear on Mr. Sanchez's Exhibit.

54. Staff asked Dr. Wilson for his views on whether lines 14-16 on JLA-8R should be used in this Docket:

> Q. As you just stated, page 3 of 4 of JLA-8R includes lines 14, 15 and 16; and those go to the venture bonds, refinance debt and capital lease.
>
> A. Yes.
>
> Q. Which were not included in SPS-1.
>
> A. Right.
>
> Q. At this time, would you recommend revising the long-term debt rate in JW-1 to reflect lines 14, 15 and 16?
>
> A. No. If you will recall, Ms. Wright did, as you did, yesterday ask some questions about those numbers of Mr. Austin; and he was unable to answer those questions to the point where one could make a determination as to whether or not the Company's filing in this case, this direct case was wrong.
>
> I don't know what that capital lease is that is being referred to and included in Mr. Austin's rebuttal exhibit. I don't know what that refinancing is. I have not seen any documentation of that in the Company's financial statements. The only indication that I have seen of it is in Mr. Austin's rebuttal exhibit, and he did not testify that the other exhibit was wrong, so I would go with what was in the filing. (Tr. Vol. II, pp. 70-71)

55. On February 17, 1993, GTE-NW filed a late filed exhibit which supported lines 15 and 16 on Mr. Austin's exhibit JLA-8R, page 3 of 4. Line 15 showed an amount of Net Proceeds Outstanding of $(12,984,461) and an Annual Effective Cost of $841,334. (See columns J & K respectively) The late filed exhibit indicates that this unamortized discount and issuance expense related to four first mortgage bonds which were refinanced. The most recent date of this group of refinanced first mortgage bonds was 1986. Thus, this information was known to

GTE-NW at the time the case was filed and should have been included on Mr. Sanchez's Exhibit SPS-1. Adding this information in Mr. Austin's Rebuttal Exhibit appears to be an attempt by GTE-NW to make up for a deficiency in its direct case.

56. The late filed exhibit provided support for line 16 which shows that three capital leases which have Net Proceeds Outstanding of $8,216,752 and an Annual Effective Cost of $829,899 relate to the following equipment:

1) Capital lease associated with heavy trucks located in the state of Washington

2) Capital lease associated with sedans and light trucks located in the state of Washington

3) Capital lease associated with Cessna Citation airplane located in the state of Washington

Commission Decision

57. GTE-NW's initial filing included Mr. Sanchez's Exhibit SPS-1 which shows long-term debt of $491,723,571.

58. MCC recommended including $493,350,000 of long-term debt in the capital structure. Again, that number is taken from page 16 of GTE-NW's 1991 annual report.

59. GTE-NW's rebuttal filing included Mr. Austin's Exhibit JLA-8R page 3 of 4 which showed long-term debt of $490,764,000.

60. The Commission finds that the appropriate amount of long-term debt in this Docket is $491,723,571 as shown on GTE-NW's Exhibit SPS-1. The reason for that finding is twofold: 1) line 14 on Mr. Austin's Exhibit JLA-8R reflects a debenture which matured on 2/1/92. It is proper to eliminate that line because the debenture expired within the twelve month period for known and measurable changes and 2) line 16 of that exhibit reflects three capital leases for property which is situs in the state of Washington. GTE-NW failed to meet its burden

of proof, with respect to showing that those capital leases are necessary to provide telephone service in its Montana service territory. Dr. Wilson recommended an amount of $493,350,000 for long-term debt. The Commission declines to use that amount because it was unable to determine that the cost of $493,350,000 of long-term debt had a cost rate of 8.821 percent.

Cost of Long-Term Debt

61. Dr. Wilson recommended a cost of long-term debt of 8.821 percent.

62. Mr. Austin recommended a cost of long-term debt of 9.212 on his Rebuttal Exhibit JLA-8R page 3 of 4.

Commission Decision

63. Based upon the concerns noted above with Mr. Austin's Exhibit JLA-8R p. 3 of 4, lines 14-16, the Commission finds the cost of long-term debt in this Docket to be 8.821% as shown on GTE-NW Exhibit SPS-1 and MCC Exhibit JW-1.

Cost of Short-Term Debt

64. Dr. Wilson recommended a cost of short-term debt of 3.847 percent. The source of the 3.847 percent is the Company's response to Data Request MCC-112. That response indicated that the short-term debt was issued from April 23, 1992 to June 30, 1992.

65. Mr. Austin recommended a cost for short term debt of 4.889 percent. The source of the 4.889 percent is Mr. Austin's Rebuttal Exhibit JLA-8R page 2 of 4. That exhibit is based on short-term debt which was issued from November 21, 1991 to December 30, 1991.

Commission Decision

66. Both short-term debt cost rates are derived from time periods beyond the test year but within the twelve month period for known and measurable changes. Comparing Mr. Austin's

cost to forecasts for short-term rates for 1993 and 1994 hardly qualifies as a known and measurable adjustment. The Commission finds that the more recent cost of short-term debt of 3.847 percent provided by Dr. Wilson be used in this Docket.

Cost of Preferred Stock

67. Both parties agreed that the cost of Preferred Stock is 8.276 percent. The Commission therefore accepts the cost of Preferred Stock of 8.276 percent.

Cost of Common Equity

68. The Company did not address the issue of cost of equity in its prefiled case.

69. Dr. Wilson determined the cost of equity for GTE-NW in this Docket to be 11.0 percent. That return on equity was derived using the discounted cash flow (DCF) approach. In his testimony at page 17, Dr. Wilson explained the DCF model:

> The DCF model is based upon two fundamental principles. First, it is based on the principle that rational investors evaluate the risks and expected returns of securities in the capital markets and establish a price for a particular security which adequately compensates them for the risk they perceive. Second, the model is based upon the proposition that the total return received by shareholders consists of dividends and capital gains, and these are measured in terms of the current dividend yield plus the expected rate of dividend growth. The DCF model, which combines yield and growth information to produce the total return expected by investors, is the following:
>
> Total Return to Investor = Current Dividend Yield + Expected Dividend Growth Rate.

70. Dr. Wilson performed a DCF study of the cost of common equity capital for fourteen investor-owned telephone companies including GTE. Exhibit J.W.-3 summarizes his DCF analyses of common equity costs for telephone companies. This analysis indicated that the prevailing common equity cost on a company-wide basis for diversified telephone companies has

declined to less than 10 percent at the present time. Since the jurisdictional services that are the subject of this proceeding are among the lowest risk telephone enterprises, this DCF evidence supports a common equity return allowance in the 9.0 to 10.0 percent range in this case. Exhibit J.W.-3 combines current dividend yields (defined as the average yield for the most recent six months) with the growth rates implied by earnings retention rates. Dr. Wilson cited Commission Order 5046d (U S WEST) which stated: "The Commission finds that using the current dividend yield is preferable to using an expected growth yield."

71. Comparable earnings were also examined by Dr. Wilson in arriving at his return on equity recommendation. Dr. Wilson explained why he examined comparable earnings:

> "Comparable rates of return are generally considered by regulatory commissions in determining fair earnings rates in utility rate proceedings. Indeed, regulatory standards demand that Commissions make an effort to allow similar profit rates to firms in similar circumstances."

72. Exhibit J.W.-4 was a tabulation reflecting the earned rates of return over the 1985-1991 period for comparable telephone companies.

Exhibit J.W.-5 showed earned return data by industry for large U.S. companies from 1985-1991. The source for the data on Exhibit J.W.-5 was Business Week. In 1988 the average industry-wide return increased to nearly 15 percent but, according to the Business Week article describing the 1988 data, almost half of the 1988 increase in profitability resulted because a statutory reduction in corporate tax rates encouraged industry to defer income into 1988. By 1990 average realized returns dropped back to 11.7 percent as money costs continued to fall, and in 1991 they declined to 8.8 percent.

73. Dr. Wilson noted that there are problems with using earned returns from the unregulated sector as a benchmark. The unregulated non-utility industries are generally more

risky because their profits are less stable and less predictable, to the extent that earnings in unregulated enterprises exceed the cost of capital. This constitutes an inflated regulatory standard and allows some firms and some industries to earn rates of return persistently in excess of their costs of capital.

74. The reported comparable earnings data reflects the annual operating results of surviving enterprises. Because investors are aware of the fact that some enterprises succeed and some fail, the reported profits of surviving firms tend to overstate true comparable earnings and, thus, the cost of capital.

75. At page 24 of his testimony, Dr. Wilson gave his conclusions for the comparable earnings data. Earnings in the telephone industry have been in the 12 to 15 percent range in recent years. The return on common equity for all industries (regulated and unregulated) has ranged between 8.8 and 14.8 percent. Given today's low money costs and the relatively low risks of the basic telephone service enterprise, the results support a common equity return allowance in the 10 to 11 percent range in this case, according to Dr. Wilson.

76. Beta coefficients were discussed by Dr. Wilson beginning at page 25 of his testimony. The beta coefficient for the common stock of a particular firm is a measure of the sensitivity of that stock's price to overall fluctuations in the New York Stock Exchange Composite Average. A Beta coefficient of 1.5, for example, indicates that the price of a stock tends to rise (or fall) 1.5 percent with a 1.0 percent rise (or fall) in the New York Stock Exchange Composite Average. Beta coefficients, as reported regularly by Value Line, are derived from a least squares regression analysis between weekly percent changes in the price of a stock and weekly percent changes in the New York Stock Exchange Composite Average over a period of five years.

77. Exhibit J.W.-6 shows the Beta coefficients for comparable telephone utilities. The average Beta coefficient for these telephone utilities was less than 1.0. This indicates that, on average, telephone utility common stocks are less volatile than the stock market as a whole. According to Dr. Wilson telephone utilities also have high safety rankings and high price stability rankings as established by Value Line. Finally, the telephone utility industry's average earnings predictability is very high according to Value Line.

78. Dr. Wilson found that it is logical to conclude that investments in unregulated competitive enterprises are more risky than investments in regulated telephone utilities. Since unregulated competitive enterprises are more risky than regulated telephone utilities, it would be poor regulatory policy to permit utilities to earn profits in excess of or equivalent to earnings in the competitive sector.

79. Based on DCF and comparable earnings studies, Dr. Wilson determined that under present financial market conditions an appropriate common equity return allowance for jurisdictional telephone utility service is in the 10 to 11 percent range. This is within the somewhat broader range of 9 to 12 percent indicated by the DCF (lower end) and comparable earnings (upper end) studies. Dr. Wilson's recommended common equity return allowance of 11.0 percent takes into account the ultimate 33.9 percent actual common equity ratio after making the double leverage adjustment.

80. Mr. Austin recommended that GTE-NW be allowed a rate of return on equity of 13.5 percent. Mr. Austin provided a list of disagreements he had with Dr. Wilson's use of the DCF model:

1) Use of a current dividend to estimate the expected dividends in the DCF model. Dr. Wilson's application of the DCF model is not based on the level of dividend payments expected by investors and thus underestimates

the expected return on equity.

2) The dividend yield should have been modified to account for the quarterly nature of dividends. Dr. Wilson ignores the time value of quarterly dividend payments and thus underestimates the expected return on equity.

3) The growth rate for utilities in the DCF model should be the expected growth rate. The evidence indicates that investors expect substantially higher growth rates than Dr. Wilson found. Also there are methodological and conceptual errors in his method for estimating growth.

4) The lack of proper allowance for flotation costs. Dr. Wilson does not allow for flotation costs thereby underestimating the expected return on equity.

81. Mr. Austin asserted that use of a current dividend yield is contrary to the spirit and fundamentals of the DCF model and fails to measure the dividend flows expected by investors. Because the appropriate dividend to use in a DCF model is the prospective dividend rather than the current dividend, Dr. Wilson's approach understates the proper dividend yield in every instance in which he applied the DCF model. Mr. Austin concluded that Dr. Wilson by using a current dividend yield, underestimated the cost of equity by approximately 19 basis points as shown on Exhibit JLA-1R, Page 1 of 5.

82. As noted above in number 2 of Mr. Austin's disagreements, Mr. Austin did not agree with Dr. Wilson's use of the traditional DCF model which assumes that dividends are paid annually. In fact most utilities, including all of the companies used by Dr. Wilson in his DCF model, pay dividends on a quarterly basis. As shown in Exhibit JLA-1R, page 2 of 5, the use of the annual version of the DCF model understates the cost of equity by approximately 24 basis points.

83. Mr. Austin indicated that in his DCF analysis of GTE-NW, Dr. Wilson estimated the growth component using growth rates implied by earnings rates. Dr. Wilson multiplies the

GTE Telephone Companies' average earnings retention rate by the average earned return on equity for each year from 1985 through 1991. Dr. Wilson adopts a growth rate of 4.66 percent for the fourteen telephone companies based on the data as shown on his Exhibit J.W.-3. Mr. Austin stated that the earnings retention growth method is only accurate under the assumptions that the return on book equity (ROE) is constant over time and that no new common stock is issued by the company, or if so, it is sold at book value. Mr. Austin noted that Dr. Wilson's Exhibit J.W.-4 shows that ROE for GTE and other telephone companies has fluctuated substantially over the years 1985 through 1991. Mr. Austin also asserts that GTE Corporation has sold new common stock at prices that differ from its book value.

84. Mr. Austin also criticized Dr. Wilson's recommended return on equity of 9.826 percent as being far below the historical ROE's for GTE and the other 13 telephone companies he used in his earnings retention growth method as shown on his Exhibit J.W.-3. Mr. Austin then concluded that Dr. Wilson is requesting that the Commission adopt two different returns.

85. Mr. Austin's third criticism of Dr. Wilson's earnings retention growth rate was that empirical evidence and finance literature did not support the earnings retention growth method as a proper explanatory variable of value, or that it is significantly correlated to measures of value such as stock price and price/earnings ratios.

86. Finally, Mr. Austin stated that proper implementation of the DCF model requires that the fraction of earnings <u>expected</u> to be retained by the company be multiplied by the <u>expected</u> return on equity. Mr. Austin feels that the systematic compilations of analysts' forecasts such as those tabulated in <u>Institutional Brokers' Estimate System</u> (IBES) provide a good proxy for investors' growth expectations when applying the DCF model. Mr. Austin argued that recent data from IBES, for Dr. Wilson's 14 telephone companies as shown in column E of Exhibit JLA-

3R, page 1 of 2, indicates that investors expect the average expected growth rates for the fourteen telephone companies to be 7.56 percent and for GTE to be 9.30 percent, contrary to Dr. Wilson's 4.66 percent range. Dr. Wilson's growth estimate understates the cost of equity by approximately 301 basis points as shown on Exhibit JLA-1R, Page 3 of 5.

87. Mr. Austin argued that an allowance for flotation costs is needed to properly determine the cost of equity. According to Mr. Austin, flotation costs have a direct and an indirect component. The direct component is a compensation to the security underwriter for marketing/consulting services. The indirect component represents the downward pressure on the stock price as a result of the increased supply of stock from the new issue. This is referred to as "market pressure." According to Mr. Austin, on average the decline due to market pressure has been estimated at 2 percent to 3 percent. Mr. Austin believes that a 5 percent allowance for flotation costs is a **conservative** estimate for this case. Dr. Wilson's failure to include flotation costs understates the cost of equity by approximately 27 basis points.

88. Mr. Austin did not agree with the comparable earnings approach used by Dr. Wilson. Rather than using earned returns, Mr. Austin felt that the focus should be on investor expectations. As an example, Mr. Austin noted that Value Line expected a return on equity for Dr. Wilson's comparable companies of 13.3 percent for 1992, 14.1 percent for 1993, and 15.8 percent for 1995-1997. GTE Corporations' return on equity was expected to be 17.0 percent in 1992, 18.0 percent in 1993, and 20.5 percent for 1995-1997. After recalculating the cost of equity using the appropriate dividend yield and payment frequencies, growth estimates and flotation costs, Mr. Austin on Exhibit JLA-3R, page 1 of 2, derived an average cost of equity of 13.05 percent.

89. Mr. Austin stated: "Dr. Wilson relied solely on his DCF and comparable earnings

analysis for his recommendation. Relying solely on these two methods diminishes the validity of Dr. Wilson's analysis."

90. In addition to a DCF analysis Mr. Austin prepared a risk premium analysis and developed a Capital Asset Pricing Model (CAPM). Using Ibbotson Associate's SBBI database to compute the average risk premium of common stocks over corporate bonds for the period from January 1, 1926 through September 30, 1992, Mr. Austin derived a risk premium of 6.36 percent. Multiplying this by the computed Beta from Value Line for Dr. Wilson's 14 telephone companies (0.89 percent as shown on Exhibit J.W.-6) gives a minimum risk premium of 5.66 percent. Added to the yield on GTE-NW "AA" bonds which was 8.67 percent, Mr. Austin derived a required return on equity of 14.33 percent, as shown on Exhibit JLA-4R.

91. According to Mr. Austin the CAPM is a derivation of the risk premium model. In his study he used the July 17, 1992, Betas for Dr. Wilson's comparable companies. Mr. Austin's CAPM study resulted in a 13.92 percent required return on equity as shown on Exhibit JLA-5R, page 1 of 2.

92. Based on his analysis (three cost of equity models: DCF, Risk Premium and CAPM) Mr. Austin recommended a 13.5 percent return on equity in this case.

93. At page 5 of his rebuttal testimony, Mr. Austin stated: "Dr. Wilson's discounted cash flow or DCF analysis uses a spot or current dividend yield." Ms. Wright asked Mr. Austin about the dividend and stock price used by Dr. Wilson:

Q. Isn't it also true that Dr. Wilson used an average price in his DCF calculations rather than a spot price?

A. Yes. (TR. Vol. I, p. 121)

94. During the hearing Ms. Wright asked Mr. Austin a series of questions about the IBES forecasts shown on Exhibit JLA-1R. Column E on the first page of that Exhibit is a single median forecast for each of the companies. Mr. Austin appeared to be confused about the term median. He explained that the forecast is the consensus of a group of analysts. He admitted that he did not know how IBES calculates the median. (TR. Vol. I, pp. 123-124)

95. MCC asked for a late-filed exhibit showing the names of the analysts who prepared the forecasts. On February 17, 1992, GTE-NW filed a late-filed exhibit which listed the analysts who provided forecasts to IBES concerning annual growth forecasts on Mr. Austin's Exhibit JLA-1R.

96. At page 126 of Vol. I of the transcript Mr. Austin admitted that he did not know the extent to which past IBES median annual growth forecasts had actually materialized.

97. During the hearing Ms. Wright asked Mr. Austin a series of questions concerning GTE-NW's flotation costs. Mr. Austin agreed that absolutely none of GTE-NW's common stock was the result of a public offering.

98. Mr. Austin noted that GTE-NW planned to sell $20 million in stock to its parent GTE. However, he admitted that the dollar value of the costs that GTE-NW would incur in this transaction would be small.

99. Ms. Wright asked Mr. Austin about the risk-free rate of return shown on Exhibit JLA-5R, page 1 of 2. Mr. Austin agreed with Ms. Wright that T-bills are below the risk-free rate (which Mr. Austin identified as 20 year Treasury bonds). T-bills were below 3 percent compared to 7.41 percent for the risk-free rate. However, Mr. Austin stated that even though T-bills are below the risk-free rate, he doesn't agree that the T-bill rate should be used in the CAPM.

100. In its brief, GTE-NW noted that Mr. Austin chose to recommend a conservative required return on equity of 13.5 percent based on his three analyses. The recommendation, based on his professional judgement, is neither the highest nor the lowest return his analyses produced, but is lower than the return on equity the risk premium and CAPM analyses produced.

101. In its brief, MCC pointed out that money costs have declined substantially. Treasury Bond rates are less than 7.0 percent, and short term T-Bill rates are about 3 percent, down from their 20 percent peaks in the early 1980s and double digit levels only a few years ago. This is evident both from today's much lower dividend yields (Exhibit J.W.-3), price/earnings ratios and comparable returns levels (Exhibits J.W.-4 and J.W.-5). An 11 percent return on equity is more than 300 basis points above GTE-NW's current long term debt rate and 800 basis points above the T-Bill rate. It also exceeds GTE Corp's dividend yield by more than 600 basis points which is well above any reasonable estimate of expected annual dividend growth.

102. Given today's money costs, a return on equity of 13.5 percent would be unreasonable on its face. Mr. Austin's ROE conclusion was unduly controlled by brokerage house analysts' self-serving bullish growth forecasts. Even when he used those forecasts, Mr. Austin relied exclusively on reported "median" forecasts, apparently without even understanding what a "median" forecast is (TR. Vol. I, pp. 123-124). Mr. Austin also failed to recognize the lack of consensus among these analysts or the extent to which their hopes and dreams are discounted by real investors. Mr. Austin included an unreasonable flotation cost in his ROE recommendation even though only about 21 percent of GTE Corp's equity involved public stock offerings and none of GTE-NW's stock was publicly issued. Finally, Mr. Austin adjusted his recommended rate of return allowance upward to reflect the fact that dividends are paid quarterly, when in fact, quarterly payments are actually more valuable to investors than annual

payments, because of the time value of money. Mr. Austin himself conceded that quarterly payments would be more valuable to him as an investor (TR. Vol. I, pp. 134-135). Thus, if anything, quarterly dividend payments would permit a slightly lower return than annual payments.

103. In its reply brief, MCC noted that the equity return should reflect current money cost conditions and not the much more costly circumstances that may have warranted returns in excess of 13 percent in the past.

Commission Decision

104. This case is unusual in that GTE-NW did not file initial testimony on the cost of capital. As a result, the testimony on the issue of cost of equity is comprised of Dr. Wilson and Mr. Austin's recommendations.

105. Flotation costs were not recommended by Dr. Wilson. Mr. Austin recommended flotation costs of 5 percent. Historically, the Commission has never granted an allowance for flotation costs. The Commission finds that the facts in this case do not support the allowance of flotation costs for GTE-NW. None of GTE-NW's stock is publicly issued. Even if GTE Corp's issuance costs are considered, it is true that only about 21 percent of GTE Corp's common equity was derived through public offerings. To allow flotation costs on the entire amount of equity for GTE Corp would result in a recovery of costs which were never incurred.

106. With respect to the payment of quarterly dividends, the Commission finds that Dr. Wilson did an effective job of explaining that dividends which are paid quarterly are more valuable than annual dividends. Mr. Austin's recommendation to increase the cost of equity to reflect the payment of quarterly dividends is rejected.

107. In terms of dividend yield, Dr. Wilson used the current declared dividend while

Mr. Austin used an expected dividend yield. Based upon both Commission precedent and the known and measurable standard, the Commission approves the dividend yield recommended by Dr. Wilson.

108. As is typically the case, the major difference between the two witnesses has to do with how to develop the growth component of the DCF model. Dr. Wilson used the earnings retention growth rate while Mr. Austin relied on the median forecasts of the <u>Institutional Brokers' Estimate System</u>. The difference between the two witnesses growth estimates was 301 basis points, which is the major difference in their respective recommendations.

109. During the hearing Mr. Austin displayed a good deal of confusion over the term median. He did not know the names of the analysts who had made the median forecasts nor did he know the extent to which past IBES median annual growth forecasts had actually materialized. Due to Mr. Austin's confusion over the IBES forecasts, and due to the fact that analysts forecasts are estimates which often have an upward bias, the Commission accepts the growth estimate offered by Dr. Wilson.

110. As a result of each adjustment above, the Commission finds that Dr. Wilson's cost of equity of 11 percent be approved in this Docket. Today interest rates are at historic lows. Given current low interest rates, the Commission finds the recommendation made by the MCC witness Dr. Wilson to be the most reasonable estimate of GTE-NW's cost of equity. Based on the above Findings of Fact dealing with Rate of Return, the Commission finds an overall rate of return for GTE-NW of 9.3684 percent as calculated below:

	Amount (000s)	Percent of Capital	Rate	Rate of Return
Long Term Debt	$491,724	34.64%	8.821%	3.0556%
Short Term Debt	122,755	8.65	8.650	.7474

Preferred Stock	7,200	.51		8.276	.0422
Common Equity	797,932	56.21	9.826*	5.5232	
Total	$1,419,611	100.00%			9.3684%

*Based on the overall cost of capital for GTE Corp. (Parent)
(See Exhibit J.W.-1)

Interest Synchronization

111. MCC witness, Mr. Kirby, recommended reducing the income tax expense by $4,706 to reflect the interest synchronization adjustment. According to Mr. Kirby, by MCC proposing more debt in the capital structure than GTE-NW, the higher level of interest creates more tax deductions than reflected in GTE-NW's tax calculation.

112. GTE-NW witness, Mr. Austin, recommended rejecting the interest synchronization adjustment based upon his objection to Dr. Wilson's proposed capital structure.

Commission Decision

113. The Commission finds that Mr. Kirby's methodology concerning interest synchronization is acceptable. Therefore, the income tax expense shall be reduced by $20,328 to reflect the interest synchronization adjustment. This adjustment is frequently made in order to assure that interest expense is appropriately reflected in the revenue requirement.

Troy Switch

114. GTE-NW witness Mr. Raymond A. Stephanson provided testimony supporting the Troy switch. Mr. Stephanson indicated that the Troy exchange would be converted to a new digital switch (Northern Telecom DMS-10) in October of 1992. He also stated that new services would be available to customers, including interstate equal access, call waiting, call forwarding,

speed calling, and remote call forwarding.

115. Testimony supporting the revenue requirement impacts associated with the Troy Switch was provided by Mr. Hub Bares. Adjustment P-10 which appeared in Column (k) on page 3 of 3 of Exhibit HGB-2 showed the total state impact of placing the new switch in Troy. Rate base increased by $597,000 and construction related expenses increased by $51,000. The same adjustment also showed the intrastate impact in which rate base increased by $381,223 and construction related expenses increased by $33,437.

116. MCC witness Mr. Kirby recommended that the Troy switch not be allowed into rates because this would distort the test year matching of revenues, expenses and rate base. He noted that GTE-NW admitted in discovery that the new switch would enable the Company to offer new services resulting in significant new revenues, yet none of the expected revenues were included in GTE-NW's adjustment.

117. Mr. Kirby also stated that the Troy switch "allegedly will be installed in the fall of 1992." In fact, the new switch in Troy was placed in service at midnight on September 26, 1992. (Stephanson Rebuttal Testimony, page 3, lines 3 & 4).

118. Mr Kirby concluded his testimony by stating that the Commission in his opinion should not allow test year adjustments to reflect the "normal and continuous process" of replacing and improving utility plant after the test year without reflecting similar adjustments for cost savings which occur after the test year.

119. MCC witness Mr. Buckalew also provided testimony concerning the Troy switch. He noted that the response to Data Request MCC-21 indicated that GTE-NW's switch study called for a host switch to be placed in Libby with remote switches in Eureka and Troy.

120. Mr. Buckalew concluded his testimony by recommending a complete

disallowance of the Troy switch replacement.

121. GTE-NW filed rebuttal testimony on November 27, 1992. Mr. Bares noted that the Commission rules allow for adjustments that take place within twelve months following the end of the test year. In addition, he stated that to disallow this item would be inconsistent with a policy of encouraging prudent modernization of telephone facilities in Montana

122. GTE-NW's original switch adjustment was revised to include additional revenues from custom calling features and the annual depreciation expense for the switch. In Exhibit HGB-1R, Column (e) of the rebuttal testimony, revenues are increased by $13,776 and the depreciation expense is increased by $24,779. The original source for the revised numbers was GTE-NW's response to Data Request MCC-105.

123. GTE-NW witness Mr. Stephanson, in his rebuttal testimony addressed Mr. Buckalew's criticisms of the Company's decision to replace the Troy switch. He stated that GTE-NW intends to use a host and remote switching topology in its Montana territory, which is common in the telephone industry. The host switch is a stand-alone switch carrying some functions such as administration, billing, maintenance and software upgrading on behalf of the remote switches. In the future remote switches are scheduled for Libby and Eureka. The use of a host and remote configuration is less expensive than giving every switch every function.

124. Mr Stephanson went on further to state that although GTE-NW's own Equipment Selection Recommendation indicated that the Libby switch would be the host, the switch in Troy ended up the host due to the Troy central office being exhausted first. Failing to replace a central office that is exhausted, with growth in access lines could lead to an increasing number of held orders. Finally, in the future GTE-NW could move the software and functionality to Libby making it the host switch, and convert Troy to a remote switch. He concluded by stating the

GTE-NW did not make any investment specifically attributable to enhanced or custom calling services.

125. At the hearing Mr. Buckalew was asked if placing the switch in Troy as opposed to Libby was imprudent or would adversely affect the ability to provide service as GTE-NW proceeds with modernization. Mr. Buckalew answered:

> "No. In fact, I don't even think that this is necessarily imprudent. In fact, I have never used those words." (Tr. Vol. II, page 34)

126. Mr. Buckalew was then asked what the potential harm was in placing the switch in Troy as opposed to Libby. Mr. Buckalew answered:

> "The potential harm is probably minimal." (Tr. Vol. II, page 34)

127. GTE-NW witness Ms. Polaski testified that there were no revenues from the sale of custom calling features for the months of October and November, and $18.50 in the month of December. (Tr. Vol. II, page 88)

128. The Commission recognizes that the originally filed adjustment to include the Troy exchange had several problems. First, GTE-NW was proposing to include a post test year addition which was more that twelve months beyond the close of the test year. This issue became moot when GTE-NW placed the switch in service within the twelve months of the test year. Next, the original adjustment included increases in the rate base and construction expense for the new switch, but failed to include revenues associated with custom calling features now available for the first time in Troy. Mr. Kirby correctly raised this point in his response testimony.

129. GTE-NW revised its adjustment for the Troy switch to include additional revenues from custom calling features and also reflected the depreciation expense associated

with the new switch. While Mr. Buckalew raised the question of cost savings associated with the new digital switch, it is unclear from the record what the exact amount of any such savings would be. The Commission finds that the revised adjustment offered by GTE-NW corrects the matching problems which were present in the original adjustment.

130. MCC raised a number of questions about the study which indicated that GTE-NW would place the host switch in Montana in Libby. Instead, what happened was the switch in Troy exhausted, and the Company replaced that switch first. That decision appears to be reasonable given the facts in this case. Mr. Buckalew declined to use the term imprudent with respect to GTE-NW's decision to replace the Troy switch. The Commission finds the new digital switch in Troy represents a reasonable management decision. The mere fact that the host switch is located in Troy rather than Libby as originally planned is simply the result of the old switch in Troy reaching exhaustion before the switch in Libby.

131. In a recent USWC Docket No. 90.12.86, MCC expressed support for the modernization plan offered by USWC, yet in this Docket MCC took the position that the new digital switch in Troy should not be allowed in rates due to matching concerns. These two positions appear to be at odds with each other in terms of modernizing the telephone network in Montana. Given the public testimony in this Docket and the correction of the matching problems, the Commission finds it appropriate to encourage GTE-NW to modernize the analog switches in Troy, Libby and Eureka.

132. MCC witness Mr. Kirby referred to the post test year addition as a "normal and continuous process." The Commission finds that the placing of a new digital switch in its (GTE-NW's) Montana service territory not to be normal and continuous, but a major plant addition. The Commission has, in the past, allowed major plant additions which occur beyond

the close of the test year to be included. An example being Montana Power Co. Docket No. 83.9.67. (See FOF No. 124, Order No. 5051c)

133. Given the above discussion, the Commission finds that the revised adjustment filed by GTE-NW which included revenues from custom calling features and the depreciation associated with the switch, as well as the increase to rate base and the increase in construction related expense should be allowed in this Docket.

Other Post Employment Benefits (OPEBs)

134. The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 106 (FAS 106) in December, 1990. FAS 106 is titled Employer's Accounting for Postretirement Benefits Other Than Pensions, and is effective for fiscal years commencing after December 15, 1992. Postretirement benefits are benefits provided by employers to retired employees in the form of payments directly to those retirees or to the third party providers of services to retirees. Examples of OPEBs are medical, dental and life insurance benefits. These benefits do not spontaneously arise when the employee retires, but are instead promised to the employee while they are still employed. FAS 106 requires that companies recognize OPEB expenses during the time employees work in order to match the expense with the time period that the benefits are earned.

135. On March 25, 1992, GTE-NW filed direct testimony in this Docket. GTE-NW witness Mr. Hubert Bares provided testimony supporting the OPEB adjustment at pages 10-11 of his direct testimony. Mr. Bares stated that for financial purposes adoption of FAS 106 was required for fiscal years beginning after December 15, 1992. He indicated that effective January 1, 1993, GTE-NW would adopt the accrual method of accounting associated with FAS 106. GTE-NW currently recognizes OPEB benefits for ratemaking on a cash, or Pay As You Go (PAYG), basis. Adjustment P-7 located in Column (h) on page 3 of 3 of Exhibit HGB-3 shows that the intrastate impact of changing from the cash method to the accrual method would be increased expenses of $62,537 and increased rate base of $12,133.

136. GTE-NW believes that the OPEB benefits are a form of deferred compensation and should be recognized as employees earn them. Mr. Bares explained that the accrual method will create a better match between costs and the events giving rise to those costs. Further, the accrual method will ensure that the full liability for these benefits will be properly reflected in the Company's accounting records. (Exh. GTE-6, p. 10)

137. On October 20, 1992, the MCC filed testimony and exhibits in this Docket. MCC witness Mr. Kirby addressed the OPEB issue at pages 7-15 of his response testimony. He recommended that the ratemaking treatment for OPEBs remain on the PAYG basis. He stated that the FASB's concerns are investor-oriented and the policy considerations that motivate the FASB should not necessarily be adopted for regulatory purposes.

138. One component of the OPEB expense under the FAS 106 accrual method is the amortization of the Transition Benefit Obligation (TBO). The TBO represents the liability related to benefits earned by retired and active employees during the years prior to implementation of FAS 106. Mr. Kirby believes implementing FAS 106 would not result in a more accurate allocation of costs to current ratepayers. In fact, due to the TBO, it would burden current ratepayers with costs unrelated to the current cost of service. Mr. Kirby maintained that this mismatch creates an issue of intergenerational equity. He stated that continuing the PAYG method would avoid the burdensome costs of shifting to a totally different accounting method. (Exh. MCC-1, pp. 10-14)

139. While Mr. Kirby objects to the accrual method being used for ratemaking, he did provide testimony on restrictions that should be imposed by the Commission if the accrual method is approved. Those recommendations are summarized as follows:

1) Allowable expenses should not exceed what can be funded in fully tax-advantaged funds.

2) Any FAS 106 accrual allowed in the cost of service must be funded.

3) The amortization period for the TBO should be extended from 20 years to 40 years. (Exh. MCC-1, p. 15)

140. GTE-NW filed rebuttal testimony on November 27, 1992. Mr. Bares discussed the OPEB issue on pages 10-14, and revised the adjustment to reflect a new actuarial study. Column (c) of Rebuttal Exhibit HGB-2R shows the effect of changing from PAYG to accrual to be an increase of $34,000 in expenses and a reduction of $12,000 in rate base.

141. GTE-NW proposed to use a Voluntary Employee Beneficiary Association (VEBA) trust to fund amounts received for the collectively bargained employees (in this Docket $5,000) and use a rate base reduction for the remaining $29,000 unfunded liability. Mr. Bares indicated GTE-NW will fund the entire amount collected in rates if so ordered by the Commission. (Exh. GTE-7, p. 12)

142. Mr. Bares opposed the recommendation from Mr. Kirby that the amortization period for the TBO be extended to 40 years. He indicated that Mr. Kirby provided no support for the extension, which "appeared to be a number chosen solely to double the amortization time period." (Exh. GTE-7, p. 13)

143. Mr. Bares stated that current customers are not paying fully for the services they are receiving and the shortfall will have to be collected from a future generation of ratepayers. This in itself creates an intergenerational equity problem. He reiterated that by using the accrual

method, the Company will recognize OPEB expenses as they are earned by the employees and properly match these expenses to the time period and customers which benefit from the services provided by the employees. Mr. Bares maintained that adoption of FAS 106 was prudent in that it mitigates future costs through the interest earned on funded amounts. (Exh. GTE-7, pp. 11-14)

Commission Decision

144. The Commission recognizes the increased level of OPEB expenses that are placed on current ratepayers when FAS 106 is implemented. However, to ignore the increasing liability and do nothing but leave it for future generations is not the appropriate course of action.

145. The accrual method represents an accurate timing match of the OPEB expense with the service received. The Commission finds that the full accrual method of accounting for OPEBs is a preferable means of matching the employee benefit costs with utility services from which those costs arose. However, as discussed below, there are limits to the amount of the accrual that are appropriate for ratemaking.

146. For FAS 106, assumptions are used in calculating the amount of the annual accrual. Mr. Bares indicated that if the assumptions used turned out to be different than actual experience, those changes would be reflected in the annual cost. Similarly, in the ratemaking process, the same assumptions will not have to be used forever. Mr. Bares stated that the self-correcting procedure for FAS 106 is similar to the mechanism already established for the treatment of pension expense. (Tr. Vol. I, pp. 92-93) The assumptions used by GTE-NW in this Docket are detailed in data request MCC-73. The Commission finds the assumptions used by GTE-NW to be reasonable.

147. The MCC proposed to extend the amortization period of the TBO from twenty years to forty years. GTE-NW opposed such an extension, stating that forty years appears to be a

number chosen solely to double the amortization time period. Mr. Kirby has not shown that a twenty year amortization period is unreasonable. Extending the amortization of the TBO an additional twenty years will, in the long run, cost the ratepayers more. The Commission finds the Applicant's proposal for a twenty year amortization period of the TBO is reasonable.

148. GTE-NW is proposing to fund only those amounts which it can fund on a tax advantaged basis ($5,000) and record the remainder ($29,000) as a reduction to rate base. This would allow GTE-NW to use ratepayer funds, from the time the OPEB liability is incurred to the time the OPEB benefits are paid, to fund investments in telecommunications services. Mr. Kirby maintained that unfunded postretirement costs are inappropriate for current recovery through rates. Without funding, no guarantee exists that the money will be available at the time the benefits are to be paid. He recommended that any FAS 106 accrual allowed in the cost of service must be funded. The Commission agrees with the MCC and observes that Mr. Bares used the benefit of funding as a reason that the adoption of FAS 106 is prudent. Mr. Bares stated "Adoption of FAS 106 is prudent in that it mitigates future costs through the accumulation of dedicated funds." (Exh. GTE-7, p.14) During the hearing the Staff asked Mr. Bares to clarify the previous statement, he responded:

> What is meant there is that as the Company sets aside funds in, for example, a trust account similar to its pension expense trust, those dollars that are set aside managed by the trustee will generate a return if properly invested. Those returns on those plan assets would then help mitigate future expenses. (Tr. Vol. I, pp. 71-72)

149. The Commission finds funding mandatory and therefore denies GTE-NW's proposal to use a ratebase reduction for the amounts that are collected in rates but not funded. The Commission finds the use of an external trustee mandatory. The trust shall restrict the use of funds exclusively for the payment of OPEBs. Mandatory funding, in an external trust that

restricts the use of funds exclusively for the payment of OPEBs, will help to ensure that money will be available to pay for the OPEBs.

150. Mr. Kirby maintained that the ratepayer cost of recognizing postretirement accruals in utility rates escalates sharply if the accruals are not matched and partially offset by a tax deduction. He recommended that allowable expenses should not exceed what can be funded in fully tax-advantaged funds. (Exh. MCC-1, pp. 12-15) The Commission agrees with Mr. Kirby's statement and finds that only amounts that are tax deductible shall be allowed in the cost of service. The Commission finds that GTE-NW shall be allowed to recover in rates the amount of the FAS 106 accrual which is tax deductible.

151. In the GTE-NW proposal, the amount of funding that is tax deductible equals $5,000. During the hearing, MCC gave GTE-NW a number of chances to clarify the amount of funding that could actually receive tax advantaged treatment. (Tr. Vol I, pp. 62-67) After reviewing the record, the Commission has determined that while GTE-NW stated that it would be willing to fund the entire accrual, the record does not support that GTE-NW can receive tax advantaged treatment for the entire accrual. The Commission finds that GTE-NW shall be allowed to include an additional $5,000 for OPEB expenses in its cost of service.

152. The Commission finds the use of a tax advantaged trust mandatory. All funds recovered in rates, for OPEBs, shall be deposited into an external trust and receive tax advantaged treatment. Again, the trust shall restrict the use of funds exclusively for the payment OPEB benefits.

153. GTE-NW indicated it would use a VEBA trust with State Street Bank and Trust Company. The Commission accepts GTE-NW's choices.

154. Upon termination of the trust and/or termination of all benefit plans providing

OPEBs, all excess funds shall be refunded to ratepayers.

155. Should GTE-NW terminate a portion of the benefit plans which provide OPEBs, GTE-NW shall present information to the Commission detailing which benefit plans were terminated, and which plans remain. GTE-NW shall provide reasons why existing funds should not be refunded to ratepayers.

156. During the hearing Mr. Bares indicated that the trustee has the ability to track the Montana funding in a separate subaccount. (Tr. Vol I, p. 73-74) The Commission finds that all OPEB funding by the Montana ratepayers shall be tracked in a separate subaccount. Also, there shall be a reasonable, proportional assignment of the total investment returns to the Montana subaccount.

157. In order to match the expense with the service rendered, the Commission finds that in the event a segment of the GTE-NW business that is currently regulated becomes deregulated, a portion of the funding that has been received shall be transferred to the deregulated entity. The Commission recognizes that funding is not done on an individual employee basis, however the amount transferred shall represent a reasonable allocation of funding that has been done for the employees in question. Equally important, 100% of the total OPEB liability for these employees shall also be transferred to the deregulated entity. The Commission recognizes that the liability for these employees may be greater than the amount of funding being transferred. Any variances shall be absorbed by the deregulated entity. In the event that GTE-NW sells its Montana properties, all OPEB funding and liability shall transfer to the new owner. All transfers shall be presented in a rate case, and reviewed by the Commission for reasonableness.

158. Cost containment measures already implemented by GTE-NW were discussed in PSC Data Request No. 44. The Commission expects GTE-NW to do everything possible to

continue to control costs associated with OPEBs.

159. As evinced by the record in this Docket, limits exist on the level of funding that is tax deductible for a VEBA trust. The Commission encourages GTE-NW to continue exploring other tax advantaged alternatives for the funding of OPEB benefits.

160. The OPEB issue as reviewed by the Commission in this Docket was limited to the question of whether to allow a change from the PAYG method to the FAS 106 method. The Commission has **not** reviewed the level of benefits or the benefit programs offered by GTE-NW. The Commission retains the right to review the level of OPEBs and the OPEB programs offered by GTE-NW in future dockets.

161. The Commission emphasizes the conclusions reached in this Docket pertaining to OPEBs apply solely to GTE-NW. The rapidly changing health care environment, the differing nature of OPEBs offered and the appropriateness of each utility's management decisions to control these costs now and in the future, all require a review of each utility on a case-by-case basis.

Private Line

162. GTE-NW did not address the issue of private line in its prefiled case.

163. MCC presented the testimony and exhibits of Mr. David Kirby. Mr. Kirby stated that GTE-NW's case did not reflect the removal of private line revenues, expenses and investment from the intrastate cost of service as required by the deregulation of private line service in Montana. MCC's other witness on this issue, Mr. Buckalew, stated that it was not until a conference call on October 15, 1992, that GTE-NW admitted that they did not remove any costs for private line service.

164. GTE-NW witness, Mr. Bares, in his rebuttal testimony, stated that private line

services and special access service are offered from the same tariff in Montana because they are physically and functionally the same service. According to Mr. Bares, GTE-NW in fact detariffed special access and private line services after passage of the Montana Telecommunications Act, but retariffed them after the Montana district court decision in AT&T Communications vs. Department of Public Service Regulation (Lewis and Clark County No. 86-1246, October 30, 1987).

165. Mr. Bares stated that private line costs should not be removed from the test period results because that service is tariffed in Montana due to the consent decree issued by Judge Harold Greene in United States vs. GTE Corporation. This requires that access services be offered under tariff.

166. Mr. Bares provided an adjustment to reflect the retariffing of Intrastate Special Access Service. This adjustment which increased Network Access Revenues by $61,566, can be seen on exhibit HGB-1R, line 4, column (i).

167. During the hearing, Mr. Buckalew stated that "when you add up the revenue requirement for all the private line services, you get $172,738. When you add up the revenue, it's $92,480 for a shortfall of $80,258." (TR. Vol. II, pp. 20 &21)

168. From page 78 to page 86 in Vol. II of the transcript there are questions to Mr. Bares on the subject of private line. Those questions addressed among other things the issue of the $80,258 revenue requirement shortfall identified by Mr. Buckalew. Mr. Bares disagreed with Mr. Buckalew's conclusion. He noted that one of the columns (identified with the heading PLO) on the response to Data Request MCC-131 showed costs of $59,379 and revenues of $61,282. Mr. Bares was asked about the two columns to the left of the column titled PLO with the headings PSI and PSL. Mr. Bares stated that those columns represent special access.

Mr. Bares stated that Mr. Sanchez was responsible for preparing the answer to Data Request MCC-131. MCC asked Mr. Bares to read into the record the following sentence from that response: "The intrastate private line revenue requirement is the total of line 2590 in columns PSI, PSL and PLO of the attachment."

169. Mr. Bares then stated that adding the numbers on line 2590 in columns PSI, PSL and PLO produced a number of $172,738. Adding the numbers on line 2600 in columns PSI, PSL, and PLO produced a number of $92,480. Mr. Bares agreed that subtracting $92,480 from $172,738 produces a number of $80,258.

170. According to GTE-NW, the private line services that MCC calls special access results in a regulated revenue shortfall, but as the MCC apparently concedes, federal law requires that these services be offered on a regulated basis. GTE-NW is willing to remove the private line service from its restated results of operations.

171. MCC stated that "There is no doubt that GTE-NW included private line service costs and revenues in its regulated costs and revenues, even though private line service was deregulated under the 1985 Montana Telecommunications Act." In its brief MCC cites U S WEST's treatment of private line as a deregulated service. MCC agrees that U S WEST provides a similar service (special access) to interexchange carriers on a tariffed basis as required by the district court. Nothing in the Modified Final Judgement governs the provision of intrastate private line service, however, that is, private line service to intrastate end users other than interexchange carriers, and under Montana law this service is deregulated. It is these costs and revenues that are at issue.

172. MCC stated that the most reasonable way of treating the problem is for the Commission to grant no rate increase at all. Another alternative is available. That would be to

make an adjustment to eliminate the $80,258 shortfall identified by MCC. MCC cautions that even making this adjustment will not solve the whole problem due to the effect of private line on separations. In conclusion, MCC noted that if the shortfall is included in this case, then local exchange ratepayers will be forced to pay that amount because the company did not propose a rate increase in this case for private line.

Commission Decision

173. As a result of the district court ruling in the AT&T case, special access is a regulated service in Montana. Both GTE-NW and MCC agree on that issue, which the Commission accepts.

174. In its initial filing GTE-NW did include expenses but failed to include revenues for special access. Mr. Bares made a $61,566 adjustment to include special access revenues in his rebuttal testimony. Thus, with the rebuttal adjustment both revenues and expenses for special access are included in the cost of service as both parties agree that they should be. Again, the Commission accepts this agreement.

175. The Commission agrees that MCC correctly identified the point that GTE-NW failed to remove private line as U S WEST and PTI Communications have done in recent cases. Although the private line and special access issue has been filled with contention throughout the case, MCC achieved a major concession from GTE-NW in that the Company admitted that they had not reflected special access revenues of $61,566.

176. The Commission agrees with both parties that private line revenues and expenses are included in the cost of service. GTE-NW says that it is willing to remove private line, but notes that doing so will slightly increase the revenue requirement. The slight increase referred to by the Company can be seen through an examination of the column entitled PLO on the second

page of Data Request MCC-131. Private line revenues of $61,282 less the private line revenue requirement of $59,379 gives a positive contribution to revenue requirement of $1,903.

177. The Commission finds that due to the small size of the adjustment, that no adjustment for private line should be made. However, the Commission does find that GTE-NW made a gross error in not removing private line, and instructs GTE-NW that in any and all future rate cases special access is to be included and private line is to be **excluded**.

Separations

178. GTE-NW witness Mr. Hubert Bares provided testimony supporting separations. Mr. Bares stated that the Company performed cost studies to develop factors which were used to separate total Montana financial results between the interstate and intrastate jurisdictions. The methodology used to develop jurisdictional factors is prescribed by the FCC in its Part 36 rules.

179. Mr. Bares' Exhibit HGB-2 reflects Montana total state results of operations. His Exhibit HGB-3 next shows the Montana intrastate results of operations **after** separations have been performed.

180. In 1986 the FCC ruled that the Subscriber Plant Factor (SPF) (pronounced spiff) which apportions subscriber and non traffic sensitive (NTS) investment to the interstate jurisdiction should be lowered to 25 percent. The eight year phase in to 25 percent concludes in 1993.

181. Prior to 1988, Central Office Equipment, (Old Category 6, New Category 3) was defined as Local Dial Switching Equipment. Examples of this equipment include the basic switching train, toll connecting trunk equipment, tandem trunks and toll completion trains. The old separations procedures divided the category into traffic sensitive (TS) and non-traffic sensitive (NTS). In 1988 the FCC implemented a five year plan to transition from the Dial Office

Factor to Dial Equipment Minutes (DEM). The 5 year phase in began with 10 percent of the change being reflected in 1988 and 20 percent in each of the succeeding four years. The new DEM factor for allocating Category 3 plant to interstate does not divide the category into TS and NTS investment. In 1993 the phase in to relative DEM is complete.

182. Mr. Bares made a pro forma adjustment to reflect 1992 SPF and DEM factors rather than the factors which were in the test year. Exhibit HGB-3, page 3 of 3, Col. (b) shows the pro forma adjustment for the update of the SPF and DEM factors. The adjustment increases operating expenses by $48,114.

183. MCC witness Mr. Buckalew noted that costs for interstate services and deregulated services must be removed from the regulated revenue requirement. He argued that GTE-NW has not supported its removal of interstate costs.

184. Mr. Buckalew compared Exhibits HGB-2 & HGB-3, noting that if one subtracts intrastate from total state what you are left with is interstate. He then calculated an interstate rate of return of 24 percent which he concluded is higher than the authorized rate of return.

185. It is Mr. Buckalew's view that both the deregulated and separations adjustments made by GTE-NW are suspect. He believes that more costs were assigned to the intrastate jurisdiction than were justified. He recommended that a separate proceeding be started to examine both jurisdictional separations and the methods used to remove deregulated costs.

186. GTE-NW filed rebuttal testimony on November 27, 1992. Mr. Bares provided an Exhibit (HGB-3R) consisting of four pages. Page 1 of that rebuttal exhibit summarized the detailed jurisdictional splits to the financial line item level. Pages 2 through 4 of the exhibit show the separations factors at the four digit FCC account level. Mr. Bares did not agree with Mr. Buckalew's analysis and conclusion because it did not consider that differences exist

between the Montana rate base and the FCC rate base, that Montana jurisdictional differences do not apply to the interstate jurisdiction and that the FCC monitors these results of operations using a different study area than the one used by the PSC in Montana. Finally, Mr. Bares reiterated that GTE-NW had performed cost studies which were in accordance with the FCC's Part 36 Separation Rules.

187. MCC indicated in their opening brief that GTE-NW's failure to remove private line affects the Company's separations factors in such a way as to overstate its intrastate revenue requirement. MCC stated that according to the FCC's Part 36 rules, both private line and special access services are direct assignments and must be removed before separations factors are applied. MCC argues that the Commission should deny the Company's application or in the alternative, it should delay any increase pending a complete investigation of private line and separations issues.

Commission Decision

188. The central argument advanced by MCC is that the Company failed to properly remove the costs associated with private line which is deregulated in Montana. A consequence of failing to properly remove private line is that the separations process is affected by what is done with private line. Since the Commission chose to make no adjustments for private line, the Commission choses to do the same with the issue of separations.

189. The other point made by MCC is that by subtracting intrastate numbers from total state numbers you get a rate of return of 24 percent for the interstate jurisdiction. Mr. Bares gave a number of examples in his rebuttal testimony of things which vary between the intrastate and interstate jurisdictions. Because Mr. Buckalew's calculation does not adequately reflect each item which is different between the jurisdictions, the 24 percent figure should be treated with caution.

The actual return for GTE-NW in the interstate jurisdiction may be higher or lower than 24 percent, but what that number is can't be determined without an analysis which takes into account all of the jurisdictional differences. Therefore, the Commission cannot adequately address this issue. The Commission may address this issue in any future rate cases.

Uncontested Issues

190. GTE-NW and MCC agreed on four of the revenue requirement issues in this Docket. In adopting these issues, the Commission will provide a brief description of the issue and its effect on revenues and expenses.

Inside Wire Amortization

191. MCC witness Mr. Kirby recommended that this amortization which was completed in the test year, be removed because it would not recur in the future. The amount of the adjustment was $30,276 which was a reduction to amortization expense. In his rebuttal testimony Mr. Bares stated: "The amortization of inside wire was completed in September, 1991, and was inadvertently included in this filing. The cost will not recur in the future." The Commission accepts the proposal of the parties to exclude the Inside Wire Amortization of $30,276.

Pension Expense

192. MCC witness Mr. Kirby recommended that pension expense should be reduced by $14,412 to reflect the most current pension accrual rate. In his rebuttal testimony, Mr. Bares stated: "The Company revised its pension expense to reflect the expected pension expense incurred in 1992 even though it extends three months beyond the September, 1992, time period." The Commission accepts the proposal of the parties to reduce the pension expense adjustment by $14,412.

193. MCC witness Mr. Kirby recommended that the USF intrastate revenue allocation be increased by $47,775 to reflect the 1992 level of intrastate revenues. In his rebuttal testimony, Mr. Bares stated: "The MCC's adjustment includes the increased NECA USF payments through the end of 1992. This incremental amount extends three months past September, 1992. However, the Company will accept the alternate calculation used by the MCC." The Commission accepts the proposal of the parties to increase the USF intrastate revenue allocation by $47,775.

Property Taxes

194. MCC witness Mr. Kirby recommended that property taxes be increased by $25,838 to reflect actual test year expenses. Mr. Bares accepted the increase to property taxes noting the change from accrual to actual. The Commission accepts the proposal of the parties to increase property taxes by $25,838.

Revenue Requirement

195. Based on the above Findings of Fact, Attachment A shows that an increase in GTE-NW's annual revenues in the amount of $118,742 on a total company basis is necessary in order to provide the opportunity to earn an overall rate of return of 9.37 percent.

GTE-NW's Hearing Conduct

196. During the hearing, GTE-NW's witness Mr. Stephanson was asked about a potential sale of GTE-NW's Montana properties:

> Q. Mr. Stephanson, what is the position of GTE with respect to selling its Montana properties?
>
> A. Well, I've worked at GTE for 24 years, and I can tell you that the rumor of selling Montana properties has always been prevalent. I can say personally somewhat of a concern to me when I consider my employees in Montana who have over that period of time asked

about the selling of that property. I'm not aware of any sale that is imminent or currently being proposed by GTE. I have heard the rumors again recently, as I'm sure you have, that the property will be for sale or there is a buyer, but I am not aware of that at all.

Q. Have there ever been any negotiations with other telephone companies to sell the Montana properties?

A. You mean recently?

Q. At any time.

A. I have no knowledge of that. (Tr. Vol I, pp. 33-34)

197. Subsequent to the hearing, GTE-NW informed the Commission that Confidential Offering Memorandums (COMs) were sent to parties between the dates of February 24 and March 17, 1993. Mr. Stephanson testified on February 9, 1993. The Commission concludes that at the time of the hearing, the Applicant knew that the potential for a sale existed and that COMs would be issued shortly. It is the responsibility of GTE-NW to provide a policy witness who is knowledgeable of the current status of the Montana properties. The Commission finds that the Applicant, not just the witness, had a responsibility to be forthcoming with the Commission. The Commission finds that GTE-NW acted in bad faith or imprudence in the conduct of its case.

COST OF SERVICE AND RATE DESIGN

198. As background, the Montana Commission has, since the early 1980s, consistently tried to set prices based on long-run marginal costs while recognizing utility revenue requirements and public interest concerns. This effort has been applied to telecommunications as well as natural gas and electric utilities. The Commission's pricing philosophy is intended to promote efficient allocation of scarce resources to the provision of regulated utility services while ensuring access to these services at reasonable costs to consumers. This philosophy provides the basis for the Commission's findings on cost of service and rate design issues in this

docket. The findings below will first discuss the cost information provided by GTE-NW in this docket and MCC's response to that cost information. The parties' rate design proposals will then be summarized followed by the Commission's decision.

Cost of Service

199. The record in this docket includes the cost studies provided by GTE-NW and the MCC's criticism of those cost studies. GTE-NW states that it supplied three cost studies that show the cost of providing local access service. (Brief of GTE Northwest p. 21) One of the three filed cost studies GTE asserts to be a forward looking marginal cost study while the other two are embedded cost studies. (id) At the technical hearing held in this case, GTE stated that its cost studies only calculated loop costs and did not include any switching or interoffice transport cost calculations. (Tr Vol I pp. 15-16) In addition, GTE stated that its forward looking marginal cost study assumed that the entire local loop system was rebuilt using current technology and equipment and that no costs were considered sunk. (Tr Vol I p. 16) Finally, GTE stated that its proposed rate design changes in this docket are not based on the results of its cost studies. (Tr Vol I p. 18)

200. MCC's witness Mr. Buckalew, (MCC), testified that the incremental loop study provided by GTE-NW is not a marginal cost study. (Exhibit MCC-2 p. 7) In addition, MCC criticized GTE-NW's cost studies because they do not provide cost information for any complete service offerings. According to MCC, many of GTE-NW's rates may be above or below cost but the lack of cost information makes it impossible to make such a determination. (Exhibit MCC-2 p. 8) Finally, regarding rate design, MCC disagrees with GTE-NW's proposal to residually increase local network access rates on a uniform basis. MCC states that, since GTE-NW has supplied virtually no cost information, if a uniform increase is necessary it should be applied to

all services, not just local exchange. (Exhibit MCC-2 p. 9)

201. In rebuttal testimony, GTE-NW responded to the MCC's suggestion that the rate increase be spread uniformly to all local services. The Company stated that because fifty percent of GTE-NW's revenues come from local access revenues, and because GTE-NW filed under the abbreviated filing rules, it chose to increase just local access rates and a few other incidental services. The MCC's alternative would require the Company to open all of its service to a full rate review; GTE-NW stated that it does not believe this is necessary. (Exhibit GTE-2 p. 5) However, at the technical hearing, when asked if GTE-NW would object to a uniform percent increase spread over all local services, GTE-NW responded "that doesn't sound like something we would strongly oppose." (Tr Vol I p. 20)

Rate Design

202. GTE-NW's proposed rate design changes fall into four categories: directory listings, directory assistance, late payment charges, and basic network access.

Directory Listings

203. GTE-NW proposes to increase rates for additional residential and business listings as well as the rates for non-published and non-listed numbers. A comparison of the current and proposed monthly rates for these services is shown in Table 1.

TABLE 1

Service Type	Current	Proposed
Additional business listing	$1.75	$2.00
Additional residential listing	$1.00	$2.00
Non-listed number	$1.50	$2.00
Non-published number	$1.75	$2.50

The MCC supported GTE-NW's proposed directory listing price changes.

Directory Assistance

204. GTE-NW is proposing two changes with respect to directory assistance. First, the number of free monthly directory assistance calls a customer can make is reduced from five to three. Second, the charge for calls that are not free is increased from $.20 per call to $.45 per call.

205. MCC supports the Company's proposed change to three free calls per month but proposes $.35 per call rather than $.45 per call.

Late Payment Charge

206. GTE-NW is proposing to introduce a 1% late payment charge on unpaid portions of bills greater than $25 which exist 30 days following the bill due date.

207. MCC supports the Company's late payment charge proposal but recommends that the charge apply to unpaid balances which exist 60 days following the bill due date.

208. After making the above rate changes, the Company proposes to residually increase basic network access rates on a uniform percentage basis to recover the remaining revenue increase authorized by the Commission in this docket.

209. As discussed above, MCC testifies that if rates must be increased on a uniform percentage basis that the increase should apply to all local services, not just basic network access.

Commission Decision

210. In short, the Commission rejects the cost estimates provided by GTE-NW in this docket but approves the Company's rate design proposals. The reasons for this finding are explained below.

211. The Commission agrees with the MCC that the cost study which GTE-NW asserts to be a marginal cost study is not. This finding is based on GTE-NW's own characterizations of its cost study and the Commission's findings from Montana Power Company Docket No. 87.8.38. First, GTE-NW states that its cost study only calculates a loop cost, it does not incorporate switching or interoffice transport costs. The marginal cost of providing local telecommunications service minimally includes switching and interoffice transport costs in addition to loop costs. Thus, even if GTE-NW's cost study were a marginal costs study, it would not be complete and would provide no useful basis for evaluating the appropriateness of rates. Second, GTE-NW admits that its methodology assumes that the entire local loop system is rebuilt and no cost is considered sunk. The Company's loop cost represents the average annual cost per customer to completely reconstruct the loop system using current technology and equipment costs. Thus, what GTE-NW computes is the reproduction cost, not the marginal cost. The Commission rejected the reproduction cost approach in MPC Docket No. 87.8.38, Order No.

5410 (See Findings of Fact 123-125). As stated in that Order, reproduction costs do not reflect avoidable costs but are based on a fictitious system. The reproduction cost method does not reflect the actual investment plans of the Company. Accurate estimates of marginal investment costs require the use of the existing local network as the starting point. Therefore, the Commission finds GTE-NW's marginal cost estimates unacceptable and of no value in judging the reasonableness of the proposed rate design changes.

212. The Commission's finding that GTE-NW's costs are of no value in judging the reasonableness of the Company's proposed rate design provides the foundation for the Commission's decisions on rate design. Since no cost information exists, the Commission finds that GTE-NW's current rates will be used as the point of reference; that is, absent any cost information to suggest otherwise, the Commission finds it must assume that current rates are economically efficient. Therefore, in adjusting rates to recover any revenue requirement increase the Commission's goal is to maintain the assumed efficiency of the existing rates.

213. The Commission finds that the record supports approving GTE-NW's proposed rate design changes to directory listings, as MCC did not contest these changes. The Commission finds that GTE-NW's directory assistance proposal is approved except that the price shall be $.40 per request. The Commission finds this to be a reasonable compromise between the $.35 rate proposed by MCC and the $.45 rate proposed by the Company. GTE-NW's proposed late payment charge is approved. Any revenue shortfall that exists after these rate design changes are implemented shall be recovered by uniformly increasing the rates of all remaining local services. The Commission finds that residually increasing all local rates, as opposed to just the basic network access rates as proposed by GTE-NW, better meets the Commissions goal of maintaining the assumed efficiency of the existing rate relationships, given the absence of cost

and demand elasticity data.

Smart Call Service

214. There is one other rate design issue before the Commission in this case. On July 2, 1992, GTE filed to introduce Smart Call Service. This filing was assigned Docket No. N-92-50 by the Commission. Smart Call Service consists of the following eight custom calling features: Call waiting, call forwarding, remote call forwarding, three way calling, speed calling, cancel call waiting and smarter call pak (which consists of a package including call waiting, call forwarding, three way calling and speed calling) In its filing, GTE provided cost outputs from Bellcore's Switching Cost Information System (SCIS) model which indicate that GTE's proposed prices for each Smart Call feature cover its costs. Through discovery in N-92-50, the Commission attempted to obtain more detailed information about the costing methodology behind the SCIS model. GTE's response was that such information is proprietary to Bellcore and the Commission would have to go to them to get the information. Not wanting to delay the availability of new services to customers, the Commission granted interim approval of the Smart Call filing on September 29, 1992. The Commission stated in its Notice of Commission Action that a final decision regarding Smart Call Service would be based on the outcome of GTE's general rate case proceeding, Docket 92.3.12. The Commission had hoped that cost information would develop in this case which could be used to judge the reasonableness of GTE's proposed Smart Call Service prices as well as other service prices. However, this information did not develop; as explained in earlier findings, GTE's cost study is limited to local loop costs and no switching cost information exists. The MCC did not address this issue.

215. The Commission finds that Smart Call Service is finally approved for the same reasons interim approval was granted. The Commission does not want to interfere with the deployment of new service offerings that may benefit the public unless there is good cause to do so. GTE-NW is required by statute to price services above relevant costs and the of record in this case contains no evidence that these services are priced either appropriately or inappropriately. Therefore, the Commission finds that Smart Call Service can be approved.

216. Finally, the Commission finds GTE-NW's efforts with respect to marginal cost based pricing disappointing. In addition, the Commission finds GTE-NW's argument that, because it filed under the abbreviated filing requirements, more extensive cost analysis was not justified. GTE-NW's original $450,000 revenue increase request would have caused significant rate impacts -- a 34 percent increase in basic residential and business rates. It is just as important that the approximately 6000 GTE-NW customers face well-analyzed, cost based rates as it is for the approximately 200,000 US West Communications customers. Therefore, the Commission directs GTE-NW to analyze its marginal costs for most, if not all, its services and provide this cost information in its next rate case, whether it qualifies for the abbreviated filing requirements or not.

Quality of Service

217. Testimony received at the public satellite hearing indicates significant customer dissatisfaction with the quality of service provided by GTE-NW. Numerous complaints were lodged concerning repair delays, operational problems, mileage charges, and unsatisfactory multi-party line service. Based on this testimony, which the Commission finds credible, GTE-NW is ordered to address all service-related problems cited by the public witnesses.

GTE-NW is also ordered to provide a report to the Commission within six months of the service date of this Order identifying in detail all steps taken to improve the quality of service provided to customers of GTE-NW. In its next general rate case filing, GTE-NW is directed to analyze and present testimony addressing the appropriateness of mileage charges, zone charges and flat rated calling areas for GTE-NW's service area in Montana.

CONCLUSIONS OF LAW

1. GTE-NW provides regulated telecommunications services within the State of Montana, . 69-3-803, MCA, and is a regulated public utility pursuant to Montana law. Section 69-3-101, MCA.

3. GTE-NW is subject to the jurisdiction, supervision and control of the Montana Public Service Commission. Section 69-3-102, MCA.

4. The PSC has provided adequate public notice and an opportunity to be heard herein, pursuant to the Montana Administrative Procedure Act. Title 2, Chapter 4, MCA.

5. The revenue requirement, rate design and rate levels approved in this Order are just, reasonable, nondiscriminatory, and consistent with the applicable provisions of the Montana Telecommunications Act.

Sections 69-3-201, 69-3-330, and 69-3-801, et seq., MCA.

ORDER

IT IS HEREBY ORDERED that:

1. The revenue requirement, rate design and revenue levels of GTE-NW, as modified in this Order, are hereby approved.

2. GTE-NW is hereby authorized to implement increased rates, beginning November 23, 1993, designed to increase annual jurisdictional telephone revenues by $118,742. Such implementation is subject to the rate design section of this Order.

3. GTE-NW is hereby authorized an increase in annual telephone revenues of $118,742.

4. The revenue changes ordered by the Commission are in lieu of and not in addition to the increase authorized in Interim Order No. 5632.

5. GTE-NW is hereby ordered to rebate the excess revenues ordered in Interim Order No. 5632. The difference between the two Orders amounts to $14,149, and shall be rebated at an annual interest rate equal to 8.82 percent which is the cost of long-term debt for GTE-NW. The rebate shall be for the period between the effective date of Interim Order No. 5632 and the effective date of this Order, and shall be a one time credit to customers' bills.

6. The Commission holds that OPEBs accounting treatment pursuant to FAS 106 is approved subject to the restrictions and conditions contained in this Order. Findings of Fact Nos. 134-161 above are hereby incorporated herein by this reference.

7. GTE-NW is hereby ordered to comply with the quality of service findings as outlined in FOF 217.

8. GTE-NW is hereby ordered to comply with any and all directives of the Commission as described in the body of this Order.

9. The rates and charges approved in this Order shall be effective for services rendered on and after November 23, 1993.

DONE IN OPEN SESSION at Helena, Montana, this 23rd day of November, 1993, by a vote of 3 - 0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

BOB ROWE, Vice Chairman

NANCY McCAFFREE, Commissioner

DANNY OBERG, Commissioner

ATTEST:

Kathlene M. Anderson
Commission Secretary

(SEAL)

NOTE: Any interested party may request that the Commission reconsider this decision. A motion to reconsider must be filed within ten (10) days. See 38.2.4806, ARM.

TABLE OF CONTENTS

Service Date: December 7, 1993

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

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IN THE MATTER of the Application	)	
of GTE Northwest Incorporated	)	UTILITY DIVISION
for Authority to Increase Rates	)	DOCKET NO. 92.3.12
and for Approval of Tariff	)	ORDER NO. 5632d
Changes.	)	

ERRATA SHEET

On page 36 of Order No. 5632d, in Finding of Fact No. 110, the rate for Short Term Debt was incorrectly shown as 8.65 percent. The correct rate for short term debt is 3.847 percent as shown on page 21 of Order No. 5632d, Finding of Fact No. 66. As a result of this error, the following changes need to be reflected in Order No. 5632d:

1. Page 36, Finding of Fact No. 110, change the short term debt rate from 8.65 percent to 3.847 percent.

2. Page 36, Finding of Fact No. 110, change the rate of return for short term debt from .7474 percent to .3327 percent.

3. Page 36, Finding of Fact No. 110, change the overall rate of return from 9.3684 percent to 8.9530 percent.

4. Page 37, Finding of Fact No. 113, change the income tax effect of the interest synchronization adjustment from $20,328 to $11,187.

5. Page 62, Finding of Fact No. 195, change the increase in annual revenues from $118,742 to $94,252.

6. Page 73, Order Section, Paragraph 2, change the increase in annual revenues from

$118,742 to $94,252.

7. Page 74, Order Section, Paragraph 3, change the increase in annual revenues from $118,742 to $94,252.

8. Page 74, Order Section, Paragraph 5, change the difference between the two Orders from $14,149 to $38,639.

9. Please find attached to this errata sheet a Revised Attachment A, which reflects the above changes.