

STATE OF NORTH DAKOTA
PUBLIC SERVICE COMMISSION

**U S WEST Communications, Inc.
SB 2420 Residential Price Changes
Investigation**

Case No. PU-314-99-119

**U S WEST Communications, Inc.
SB 2420 Residential Price Changes
Tariff**

Case No. PU-314-00-284

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

September 20, 2000

Appearances

Commissioners Bruce Hagen, Susan Wefald and Leo Reinbold

William Binek, Commission Counsel for the Public Service Commission, State Capitol, 12th Floor, Bismarck, ND 58505, appearing on behalf of the **Public Service Commission Staff**.

Daniel S. Kuntz, Attorney at Law, Zuger Kirmis & Smith, P. O. Box 1695, Bismarck, North Dakota 58502-1695, appearing on behalf of **U S WEST Communications, Inc.**

John L. Munn, Senior Attorney at Law, U S WEST Communications, Inc., 1801 California Street, Room 5100, Denver, CO 80202, appearing on behalf of **U S WEST Communications, Inc.**

Allen C. Hoberg, Administrative Law Judge and Director, Office of Administrative Hearings, 1707 North 9th Street - Lower Level, Bismarck, ND 58501-1882, appearing as procedural hearing officer.

Preliminary Statement

On August 1, 1999, substantial changes to North Dakota's telecommunications laws took effect due to the enactment of Senate Bill 2420. One new subsection, N.D.C.C. §49-21-01.3(5), allows U S WEST Communications, Inc. (U S WEST) to raise

the price of its local residential service to \$15.50 after July 31, 1999 and to \$18.00 after June 30, 2000.

New subsection (6) to N.D.C.C. §49-21-01.3 authorizes the Commission to investigate the increased price allowed under subsection (5) and authorizes the Commission to set all or a portion of the increase aside if the Commission finds the increased price unfair or unreasonable. However, subsection (6) also provides that the Commission may not set aside an increased price as unfair or unreasonable if the Commission finds that the average cost of providing residential service exceeds the price resulting from the increase.

On July 30, 1999, in Case No. PU-314-99-119, U S WEST filed revisions to its price schedule to increase the price of local residential service to \$15.50 per month as allowed under N.D.C.C. §49-21-01.3(5). On August 11, 1999, the Commission opened an investigation to determine the average cost of U S WEST's local residential service in North Dakota and whether some or all of the price increase should be set aside as unfair or unreasonable. On August 17, 1999, U S WEST submitted an embedded cost study and supporting documentation for providing local residence service in North Dakota.

On September 10, 1999, Sprint Corporation (Sprint) filed a petition to intervene. On September 21, 1999, McCloudUSA Telecommunications Services, Inc. (McCloud) filed a petition to intervene. Both petitions were granted by the Commission on September 22, 1999. Sprint did not participate further in the proceedings and did not appear at the hearing. McCloud filed a petition to withdraw from the proceedings on June 5, 2000, and was deemed withdrawn by the Hearing officer at the beginning of the hearing.

On November 8, 1999 AT&T Communications of the Midwest, Inc. (AT&T) filed a petition to intervene, which was granted by the Commission on November 17th. AT&T subsequently filed a notice of withdrawal from the proceedings on May 26, 2000, and was deemed withdrawn by the Hearing officer at the beginning of the hearing.

On March 15, 2000 the Commission issued a Notice of Hearing, scheduling a public hearing on this matter to begin June 6, 2000. The notice identified the following issues to be considered:

1. Whether the average cost of local residential service provided by U S WEST in North Dakota, as calculated under either representative embedded or forward-looking economic cost methodologies, including shared and common costs, exceeds the price resulting from the increase;
2. If the Commission determines that the average cost of local residential service provided by U S WEST does not exceed the price resulting from the increase, whether the increased price is fair and reasonable.

On May 9, 2000, the Commission's staff (Staff) consultant filed a report setting forth findings and recommendations concerning Staff's review of the embedded cost study filed by U S WEST. On May 30, 2000 U S WEST filed testimony in response to the staff report.

On June 9, 2000, in Case No. PU-314-00-284, U S WEST filed revisions to its price schedule to increase the price of local residential service to \$18.00 per month as allowed under N.D.C.C. §49-21-01.3(5).

By this order the Commission consolidates the records in Case No. PU-314-99-119 and Case No. PU-314-00-284 for the purpose of determining the issues in this proceeding.

Analysis of Commission Authority

N.D.C.C. subsections 49-21-01.3(5) and (6) provide:

5. The monthly price of residence service for group I telecommunications companies defined in subsection 2 of section 49-21-01 may be increased after July 31, 1999, up to fifteen dollars and fifty cents and may be increased after June 30, 2000, up to eighteen dollars. A telecommunications company increasing prices under this subsection must submit a report to the commission reasonably demonstrating that it reduced the prices of its intrastate intraLATA message toll service and intrastate switched access, as such prices existed on January 1, 1999, in aggregate by an annual amount not less than the annual revenue increase resulting from the service price increases under this subsection. Reductions in message toll and switched access prices attributable to the price increases under this section must be made by similar percentages as to be accomplished in a competitively neutral manner. The commission may review the report and may set aside pursuant to section 49-21-06 the prices of intraLATA message toll service and intrastate switched access if the reductions have not been made in a revenue neutral manner and by similar percentages. Prices set aside pursuant to this section remain effective until the effective date of revised prices filed by the telecommunications company within forty-five days of the commission's order.

6. The commission may investigate an increased price allowed pursuant to subsection 5 and may set aside all or part of the increase if it finds the price is unfair or unreasonable, provided a price for residence service at or below the price in effect on January 1, 1999, may not be set aside under this subsection or section 49-21-06. The commission may not set aside all or part of an increased price as unfair or unreasonable if the commission determines after notice and opportunity for hearing the average cost of

providing residence service, as calculated under either representative embedded or forward-looking economic cost methodologies, including shared and common costs, exceeds the price resulting from the increase.

One important and preliminary issue in this case concerns the statutory authority of the Commission to make adjustments to the inputs to U S WEST's embedded cost study. U S WEST asserts that the booked amounts are the booked amounts and the Commission cannot adjust them when determining the average cost of providing residential service in North Dakota. Staff contends that the statutory mandate is for the Commission to *determine* the average cost, which necessarily implies authority to determine the reasonableness or appropriateness of the inputs to the cost study. We agree with staff that the Commission has statutory authority to make adjustments to the costs and the assignments included in a U S WEST SB 2420 cost study when the Commission believes such adjustments are necessary to provide cost study results that more reasonably reflect the cost of residential service for purposes of SB 2420.

A hearing was held as scheduled on June 6 and 7, 2000 in the Commission hearing room at Bismarck. Having heard and considered this matter, the Commission makes the following:

Findings of Fact

1. On August 1, 1999, changes to North Dakota's telecommunications laws took effect due to the enactment of Senate Bill 2420. One new subsection allows U S WEST to raise the price of its local residential service to \$15.50 after July 31, 1999 and to \$18.00 after June 30, 2000.
2. On July 30, 1999, U S WEST filed revised rates for local telephone service to be effective August 20, 1999. The fixed monthly rate for non-measured residential service was increased statewide to \$15.50.
3. On June 9, 2000, in Case No. PU-314-00-284, U S WEST filed revised rates for local telephone service to be effective July 1, 2000. The fixed monthly rate for non-measured residential service was increased statewide to \$18.00.
4. As provided for in SB 2420, U S WEST filed a representative embedded cost study on August 17, 1999. Results of U S WEST's representative embedded cost study indicate that the average monthly per access line intrastate cost of basic exchange residential service in North Dakota is in excess of \$18.00. U S WEST's embedded cost study utilized a 1998 calendar year test period and was based on data drawn from 1998 Federal Communications Commission ARMIS Reports, sub-account records, functional cost analysis/time studies and U S WEST's embedded cost accounting system know as CAAS/CARS (Cost Accounting Allocation System/Cost Accounting Reporting System).

5. The purpose of the cost study is to determine the revenue, expenses, taxes, and investments attributable to residential basic local service. The statute provides that although the cost study used may be embedded or forward-looking, shared and common costs should be included when determining whether the average cost of residential service exceeds the price. U S WEST's cost study recognizes an assessment of 25 percent of the cost to interstate services consistent with the Federal Communications Commission's (FCC's) Part 36 Jurisdictional Separations Procedures and Part 69 Access Charge rules for the separation of cost and the pricing of access charges. The remaining 75 percent of cost is assessed to intrastate services.

Loop Costs

6. The cost of providing local residential service includes investment and expenses related to the local loop, which connects each customer's home to the network and constitutes a significant portion of the costs of providing telephone service. U S WEST's cost study proposes to classify 100 percent of the intrastate cost of the loop as a cost of providing basic local exchange service. U S WEST states that assigning non-traffic sensitive loop costs to traffic sensitive services such as intrastate toll or switched access is economically unsound and would send inappropriate price signals to customers because those that use traffic sensitive services would subsidize those that do not.

7. Staff cites previous Commission decisions in Case Nos. 10,444, 10,694, and 10,699 as precedent to require that other services provisioned over the local loop be assessed a portion of the loop cost.

8. U S WEST responded that the prior Commission orders relied upon by Staff dealt with rate design and cost recovery issues rather than cost incurrence and the purpose of those proceedings was to address issues arising from the breakup of the Bell system during a time when the industry was far less competitive and circumstances were different than they are today.

9. The Commission agrees with Staff that the Commission has allocated the local loop in previous decisions.

10. Staff used an allocation feature of U S WEST's cost model to illustrate the cost impact of allocating loop costs between local service, intrastate switched access and intrastate toll based on minutes of use of the network by these services. Staff also proposed loop cost allocation for Extended Area Service (EAS). Staff contended that there may be further loop costs assigned to local service that may be more appropriately assigned to other services such as vertical and data services, but Staff was unable to quantify such costs in the record. At the hearing and in testimony, Staff recommended further proceedings to fully allocate the loop.

Extended Area Service (EAS)

11. U S WEST included EAS costs within local residential service even though customers are billed for EAS separately and in addition to charges for local residential service. Staff proposed an adjustment to remove EAS costs using an allocation based on the percentage of EAS calls weighted by hold time to total calls.

12. U S WEST agreed to Staff's proposed adjustment for EAS, except U S WEST contends the allocation should not be applied to loop costs, which U S WEST proposes to assign entirely to local service. The Commission finds it appropriate to adjust the cost study results for EAS as agreed by the parties. An additional adjustment related to EAS loop costs is addressed in the next section.

Adjustments for Loop Allocation

13. The Commission finds that U S WEST's proposal to assess all loop costs to basic local service should be rejected and a portion of loop costs should continue to be assessed to other services. The local loop is necessary in the provisioning of all services and loop costs are therefore common to all services, including EAS. The Commission finds that further proceedings to fully allocate the local loop are not practical or necessary at this time. Instead, the Commission will accept the U S WEST cost model allocations of the loop for toll and access based on minutes of use of the network by these services and the allocation for extended area service based on percentage of EAS calls weighted by hold time to local calls. These allocations will serve as a proxy for determining what portion of loop costs should not be assigned to local service in this proceeding. The Commission clarifies that the purpose of this adjustment proxy is only for determining what costs should be assigned to local residential service. This action does not assign costs to services other than local residential service and U S WEST is free to recover loop costs from non-essential services. This adjustment for loop cost allocation is consistent with previous Commission decisions cited by staff.

Cost of Capital

14. In its cost study, U S WEST used a 12.39 percent return on equity, a cost of debt of 7.30 percent, and a capital structure of 40.82 percent debt and 59.18 percent equity, which resulted in a 10.31 percent overall cost of capital.

15. U S WEST witness Peter Cummings testified that the 10.31 per cent is the estimated average monthly embedded cost of capital for 1998. The witness testified that to estimate a market required return on equity, the company uses Discounted Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) methodologies applied to U S WEST and two proxy groups of companies. The company groups chosen as proxies for U S WEST are publicly traded companies with operations in the local exchange telephone services industry, and a group of companies with risks comparable to U S WEST. Mr. Cummings' best estimate of U S WEST's market required return on common equity for December of 1998, based on DCF and CAPM, is in the range of 11.3 percent to 12.4 percent. In calculating this estimate, Mr. Cummings discarded the result of his DCF analysis for U S WEST because it was nearly two standard deviations

below the mean and therefore statistically out of range. Mr. Cummings performed similar calculations for each month in 1998 and averaged the results to obtain the return on common equity of 12.39 percent that was used in the cost study, but he did not provide details of those calculations. The detailed calculations for December 1998 were provided as an example of the method the witness used when calculating each month. Mr. Cummings further testified that the expected return for U S WEST should be slightly lower than the expected return for the Standard & Poor's 500 Index which makes up more than 80 percent of the total value of the New York Stock Exchange.

16. Staff suggested that the Commission may want to consider adjusting the cost of capital assumption U S WEST used in its embedded cost study. As an example, staff substituted an 11.25 percent return on equity and a corresponding 9.53 percent overall cost of capital in the cost study and provided the resultant impact reduction in the monthly price for residence service. U S WEST alleges that staff's cost of capital is not supported by any evidence or data and should be rejected. U S WEST made a late filed exhibit showing the authorized percent returns on equity in other states it serves. The authorized returns range from 11.2 percent to 13 percent and were set in proceedings that occurred between 1987 and 1997. An Idaho proceeding was the most recent with an authorized return of 11.2 percent in 1997.

17. The Commission's most recent cost of capital determination arose from an application by Northern States Power Company for an increase in rates for electric service, Case No. PU-400-92-399. In its order, the Commission found the DCF method to be reasonable and rejected the Equity Risk Premium and CAPM pricing analyses in determining cost of common equity. The Commission has accepted the DCF method for estimating the market return on equity in other cases as well. Based on U S WEST's DCF estimates the market required returns at the end of the 1998 calendar year test period ranged between 9.5 percent and 11.3 percent. (Exhibit 9, p. 32) Staff's suggested return of 11.25 percent is near the top of that range, and falls within the range of returns on equity authorized in other states served by U S WEST. The Commission finds Staff's suggested 11.25 percent return on common equity is reasonable and should be accepted.

Advertising

18. Staff recommended that expense related to product advertising, corporate advertising, public and community relations and general advertising not be assessed to residential service in the embedded cost study. Staff witness Ralph Smith testified that these types of advertising are intended to enhance the corporate image, and benefit shareholders. U S WEST witness Marti Gude testified that costs referred to by staff as advertising costs in Account 6722.3 include work and costs associated with 1) public and community relations including rate change announcements, corporate educational policies and corporate community relations programs and policies. 2) product specific advertising, and 3) corporate advertising.

19. U S WEST alleges these are necessary costs that in large measure are focused directly on customer relations, education and general information. U S WEST witness Wayne Culp testified that these advertising costs are necessary, particularly in today's competitive environment for local exchange service and that shareholders only benefit from advertising to the extent the advertising increases sales and revenues.

20. The Commission finds that public and community relations costs are necessary expenditures for providing local residential service. However, product specific and corporate advertising are not necessary for providing local residential service and in previous cases the Commission has not allowed these types of promotional advertising costs to be recovered in rates. The Commission will remove from the cost study, the costs of product specific and corporate advertising as detailed in Ms. Grude's testimony.

Change in Capitalization Limit

21. Staff testified that the FCC changed the capitalization limit so that items costing between \$500 and \$2000 are now to be expensed rather than capitalized, and that this change was not reflected in U S WEST's embedded cost study.

22. U S WEST witness K. Dennis Wu stated that in 1992 the Commission determined it has no authority under North Dakota price cap law to mandate Company accounting policies and also that it is inappropriate in a 1998 embedded cost docket investigation to use 1999 pro forma amounts.

23. The Commission may make adjustments to the costs and the assignments included in a U S WEST SB 2420 cost study when the Commission believes such adjustments are necessary to provide cost study results that more reasonably reflect the cost of residential service for purposes of SB 2420. However, these accounting changes were not implemented until after the 1998 calendar year test period and it would not be appropriate to make adjustments to the cost study for these out of period changes without considering other known and measurable changes such as wages, insurance expense, ratebase, taxes, etc. The Commission finds no adjustment necessary on this issue.

Capitalization of Software

24. Commission staff testified that the American Institute of Certified Public Accountants has issued a Statement of Position No. 98-1 concerning capitalization of software costs. This Statement will become part of Generally Accepted Accounting Principles and U S WEST follows these principles for financial reporting purposes. For financial reporting purposes, the accounting change requires companies to capitalize certain software development costs and amortize them over the useful life of the software beginning in 1999. U S WEST's embedded cost study did not reflect the impact of this accounting principle and Staff proposed an adjustment that used a 6 year amortization life and averaged the initial impact of the change over a three year period.

25. U S WEST witness Wayne Culp testified that, since this is not a rate of return docket, it is not appropriate to adjust the incurred embedded cost results for a future event nor does the Commission have the authority to establish a system of accounts to be kept by U S WEST. Mr. Culp also testified that, in the first year of this accounting change, there is a significant decrease to expense, but by the fifth year of the transition period related to this item, the ongoing expense level catches up to the expense level prior to capitalization.

26. The Commission may make adjustments to the costs and the assignments included in a U S WEST SB 2420 cost study when the Commission believes such adjustments are necessary to provide cost study results that more reasonably reflect the cost of residential service for purposes of SB 2420. However, these accounting changes were not implemented until after the 1998 calendar year test period and it would not be appropriate to make adjustments to the cost study for these out of period changes without considering other known and measurable changes such as wages, insurance expense, ratebase, taxes, etc. The Commission finds no adjustment necessary on this issue.

Depreciation

27. Staff stated that depreciation rates used in the embedded cost study have a significant impact on the resulting cost of residential service and provided an example of the impact by changing the depreciation rates to those being used by U S WEST in 1998 for FCC reporting purposes for U S WEST's North Dakota operations. U S WEST was requested by Commissioner Wefald to rerun its embedded cost study using the FCC depreciation rates and the results do show significant impact.

28. One of the most critical and controversial factors in determining depreciation rates is the average remaining lives of assets for each plant account. U S WEST alleges that, since the FCC's depreciation rates were last prescribed in 1995, the economic lives of embedded facilities have shortened as new technologies are deployed. Staff contends that new technologies for providing high speed data services are extending the economic life of copper wire, which constitutes much of U S WEST's embedded facilities. However, neither party presented evidence to indicate specifically what the average remaining lives of assets should be.

29. The Commission finds no evidence that the depreciation reserve percentages, average remaining life, salvage values or any other parameter used by U S WEST to set its intrastate depreciation rates were incorrect or inappropriate.

30. Staff noted a difference in the embedded cost study depreciation expense and the FCC reporting depreciation expense for Allowance For Funds Used During Construction ("AFUDC") on short term construction projects. This difference resulted from a change in the FCC accounting treatment for AFUDC on short term construction projects which was later reversed by the FCC. Because the accounting treatment was not changed for intrastate accounting, there was no need to subsequently reverse the intrastate accounting treatment. The Commission finds no evidence that the intrastate

AFUDC accounting was inappropriate and the difference in expense levels is relatively minor.

Summary of Adjustments

31. The Commission's adjustments to U S WEST's cost study for loop allocation, EAS and cost of capital are detailed in the Staff Report (Exhibit 2, Attachment 3). The adjustments for product specific and corporate advertising are detailed on pages 411 and 412 of the transcript. These documents are among those that have been granted trade secret protection in this proceeding under a process that provides a means for interested parties to review trade secret documents upon signing a nondisclosure agreement. Together, these adjustments result in a monthly cost of local residential service of \$17.76 per access line.

Reasonableness of Price

32. If the Commission determines the average cost of local residential service does not exceed the increased price allowed by SB 2420, the Commission may set aside all or part of the increased price if it finds the price is unfair or unreasonable.

33. The average cost of local residential service provided by U S WEST in North Dakota, as calculated under a representative embedded cost methodology, including shared and common costs, does exceed the prices for local residence service filed on July 30, 1999, and made effective August 20, 1999 in Case No. PU-314-99-119.

34. The average cost of local residential service provided by U S WEST in North Dakota, as calculated under a representative embedded cost methodology, including shared and common costs, does NOT exceed the prices for local residence service filed on June 9, 2000, to be effective July 1, 2000, in Case No. PU-314-00-284.

35. U S WEST alleges that \$18 per month for residential service is fair and reasonable by comparison to rates charged for residence service in other U S WEST states. Witness Culp provided a table showing the rates. We are not convinced that a price for residence service that exceeds cost can be considered fair or reasonable.

36. The Commission finds that the current price of U S West residential local service is unreasonable.

From the foregoing Findings of Fact, the Commission issues the following:

Conclusions of Law

1. The Commission has jurisdiction over the parties to and the subject matter of these proceedings.

2. The Commission may make adjustments to the costs and the assignments included in a U S WEST SB 2420 cost study when the Commission believes such adjustments are necessary to provide cost study results that more reasonably reflect the cost of residential service for purposes of SB 2420.

3. The average cost of local residential service provided by U S WEST in North Dakota, as calculated under a representative embedded cost methodology, including shared and common costs, does exceed the price for local residence service filed on July 30, 1999, and made effective August 20, 1999 in Case No. PU-314-99-119.

4. The average cost of local residential service provided by U S WEST in North Dakota, as calculated under a representative embedded cost methodology, including shared and common costs, does NOT exceed the price for local residence service filed on June 9, 2000, to be effective July 1, 2000, in Case No. PU-314-00-284.

5. The current price of U S WEST residential local service is unreasonable.

From the foregoing Findings of Fact and Conclusions of Law, the Commission issues its:

Order

The Commission Orders:

1. The records in Case No. PU-314-99-119 and Case No. PU-314-00-284 are consolidated.

2. Twenty-four (24) cents of U S WEST's \$18.00 monthly price for local residential service is set aside.

3. U S WEST shall file revised price schedules consistent with this order within 45 days of the date of this order, as provided in N.D.C.C. §49-21-01.3(5).

PUBLIC SERVICE COMMISSION

Susan E. Wefald
Commissioner

Bruce Hagen
President

Leo M. Reinbold
Commissioner

STATE OF NORTH DAKOTA

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CONCURRING OPINION COMMISSIONER SUSAN E. WEFALD

September 20, 2000

This has been a very complex case, and the Commission has spent a great deal of time studying the record and carefully interpreting new subsections of law, NDCC 49-21-01(5) and (6) which were enacted by the 1999 Legislature. This is the first time that the Commission has made a decision under this section of law. Therefore it is a case of first impression.

For years U S WEST has been saying that it needed to charge higher prices for other services because it had to subsidize residential service. With this decision, the Commission has determined that residential service now has no need to be subsidized. We are stating that the correct and full cost of residential service is \$17.76. Indeed, since customers are presently paying \$18.00 for residential service, residential service is presently subsidizing other services.

It is sad that the Legislature did not provide for a refund to customers. Customers have been paying \$18.00 since July 1, 2000. Now U S WEST has 45 days to file changes with the Commission.

Although I agree with finding 28 that the Commission does not have evidence on this record to determine that the inputs used to set U S WEST depreciation rates were incorrect or inappropriate, I am not convinced that U S WEST's depreciation rates are correct. Correct depreciation rates are difficult to pin down. Useful lives of equipment such as copper wire are not easy to establish given the changing nature of the telecommunications environment. Experts argue about useful economic lives, without a "crystal ball" that lets them look into the future. In case PU-453-96-497, which dealt with AT&T and U S WEST's interim interconnection agreement, the Commission did not use U S WEST's depreciation rates. Since the Commission in this case is not making any adjustments to U S WEST's depreciation numbers, one could make the argument that with correct depreciation rates, the correct price for U S WEST residential service may be less than \$17.76.

The decision on sharing the loop costs is a very important issue in this case. I agree with the Commission's findings in this area.

Commissioner Susan E. Wefald