Response Support #44

of future costs when setting future rates; and honesty compels it."

As stated, rates are normally set prospectively and are normally based on test period data that are presumed to be representative of prospective conditions when rates will be in use. Whether using pure historic data with actual events as reported or pure forecast data using the best available assumptions, as so well expressed by Dr. Kahn, the test period necessarily assumes the posture of a projection of future events when it is used to set future rates.

For many years, regulators relied primarily upon historic test year data with pro forma adjustments to recognize known and measurable changes in the events as recorded. In recent years, a number of state and federal regulators have acknowledged the deficiencies inherent in historic data and have adopted the projected test year approach to anticipate rapidly changing conditions more effectively and to accommodate the rate-making objective of setting prospective rates that will adequately cover prospective costs. They have recognized that test period data must be structured to accommodate the future, because the future will not develop to accommodate test period assumptions.

§ 7.03 Selection of the Test Year

Test period conditions are typically based upon one of the following test year selections:

(1) historic data;

(2) current data (partial historic and partial projected); or

(3) projected data.

The selection of the timing of the test year may be the most significant single factor in the rate-making process. The more outdated the test year levels of operations, the more critical is the need for significant restatement to produce representative levels of future conditions. As the test year selection moves from historic data toward projected data, the restatement problem moderates and the level of pro forma adjustments to restate the test year is reduced.

The historic test year approach may function reasonably well when economic conditions are stable and did so under conditions during the 1950s and 1960s. In recent years, however, it has consistently proven to be inadequate. Under the inflationary conditions

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	DOCKET NO. UT-950200
Complainant,	)	FIFTEENTH SUPPLEMENTAL ORDER
v.	)	
U S WEST COMMUNICATIONS, INC.,	)	COMMISSION DECISION AND ORDER REJECTING TARIFF REVISIONS; REQUIRING REFILING
Respondent.	)	
. . . .	)	

BACKGROUND: On February 17, 1995, U S WEST Communications, Inc. (USWC or Company) in Docket No. UT-950200 filed with the Commission certain tariff revisions designed to effect statewide a general rate increase of $204,613,922 over four years in its provision of intrastate telecommunications services. By order dated March 8, 1995, the Commission suspended the effective date of the tariff revisions pending investigation and hearing as to whether the proposed rates are fair, just, reasonable, and sufficient. The Company requested and received an extension of time to permit negotiations among parties and it waived the suspension date for a further two weeks to accommodate the hearing schedule.

COMMISSION: The Commission rejects the Company's request for increased rates and charges, and directs it to file tariffs to effect a decrease in rates of $91.5 million, which is approximately 9.8% of the Company's affected revenues.

TABLE OF CONTENTS

PART FIVE:

PART ONE:

OVERVIEW

This is an important proceeding. It comes at a defining time for telecommunications regulation in Washington state. It is among the longest proceedings the Commission has heard in years. The Commission heard from 52 expert witnesses, received nearly 800 exhibits, comprising over 10,000 pages of prefiled written testimony and documentation. The record ran to more than 4,200 pages of transcript testimony over 23 days of hearing, and 14 party intervenors participated in addition to the Company, Commission Staff, and Public Counsel. The proceeding generated as much intensity as any other Commission proceeding in recent memory.

The reason for this level of activity and intensity has been the nature, diversity, significance and magnitude of the issues posited by the Company's general rate increase filing. It is important from a historical perspective because it is the first general rate case filed by USWC since 1982, and thus the Commission's first opportunity in that time to examine the Company's overall operations. The Commission in February 1989 filed a complaint on its own motion against the Company's rates. A settlement agreement resolved the complaint and resulted in a $337.75 million rate decrease over five years. The agreement also instituted an alternative form of regulation (AFOR) for the Company, which reduced the Company's regulatory burdens.[1] The AFOR ended in December, 1994, and its termination was one of the reasons this case was filed.

This proceeding also is important from a forward-looking perspective as well: it considers policies and pricing that will carry USWC into the competitive environment mandated by the federal government in the Telecommunications Act of 1996.[2]

For years, this state's statutory and regulatory telecommunications policy has directed open markets and consumer choice, balanced by universal service concerns. This order

---

[1] RCW 80.36.135 authorizes the Commission to "waive such regulatory requirements under Title 80 RCW for a telecommunications company subject to an alternative form of regulation as may be appropriate to facilitate the implementation of this section[.]" In adopting the plan, the Commission found that the public policy goals of RCW 80.36.300 would be achieved; that the goals delineated in RCW 80.36.135 would be met; and the conditions for approving the plan contained in that statute would be satisfied.

[2] The Federal Telecommunications Act of 1996, Pub.L.No.104-104, 110 Stat. 56, to be codified at 47 USC Sections 151, et seq. The Act will also be referred to in this document simply as "the Telecom Act."

is a key part of the foundation of a sustainable competitive marketplace. Because of its importance, and the amount of money at stake, the case has drawn unprecedented interest and participation by interested parties and the public. At public meetings, and through letters and telephone calls, the Commission has heard from more citizens about this case than any other. To the members of the public who took time to express their views, we extend our appreciation.

The details of the Commission's conclusions, and specific reasons for our findings, are contained in this Order. In this introductory section we briefly summarize some of the policy principles that governed our decision and describe a number of significant issues.

I. POLICY PRINCIPLES

State telecommunications policy is governed by the Regulatory Flexibility Act, which directs the Commission to preserve universal service, promote diversity in services, ensure that competitive services are not subsidized by monopoly rates, and permit flexible regulation of competitive telecommunications companies and services.[3] The recent federal Telecom Act federalizes that same policy. It begins a new phase of competitive development in which Congress envisions robust competition in all communications markets including, significantly, the local exchange. The Telecom Act reserves substantial roles for state regulatory commissions to effect such competitive development.

Whether robust competition develops will depend on how the law is implemented at both the state and federal levels. Despite some limited competitive entry, USWC is still by far the dominant player in its service territory for virtually all services. For consumers to have competitive choice, the USWC network must be opened up at terms that are fair to both USWC and new entrants. A key part of that process is determining the costs and fair prices for USWC's services. This case, the first general rate case involving USWC in over a decade, provides a comprehensive review of the Company's overall operations. As such, it establishes a baseline from which a sustainable competitive market can emerge.

II. ISSUES

In USWC's filings and in the evidence, several key issues emerged:

A. Is the Company Entitled to More Revenues?

USWC's general rate increase filing seeks approximately $205 million a year in additional revenues, phased in over four years. It proposed approximately $95 million of that

[3]L. 1985 ch. 450, amended L. 1989 ch. 101, codified in various provisions in chapter 80.36 RCW.

total as an immediate rate increase. After reviewing the Company's operations and making a number of factual, technical and legal decisions, the Commission finds that instead the Company is over-collecting approximately $91.5 million per year. The Company will be directed to reduce rates by that amount.

B. Are Residential Rates Priced Below Cost?

Contending that residential rates are heavily subsidized, USWC proposed more than doubling residential rates over 4 years, and charging rural ratepayers significantly more than urban ratepayers. In the final year of the USWC proposal, urban ratepayers would pay $21.85 per month for service and rural ratepayers $26.35. The current statewide average rate for the service is $10.50.

USWC's own cost data -- which supports the cost study relied on by the Commission -- shows that the incremental cost of local service is less than $5 per month. Even if the entire incremental cost of the "loop" -- the facilities needed for the connection between the central office and the consumer's telephone which also carry long distance and specialized services, such as voice mail, as well as local service -- is allocated to the local ratepayer the price covers that cost. There simply is no local service subsidy.

USWC's own data show little cost difference between its rural and urban service territories. The Commission directs the Company to eliminate extended area service surcharges and establish a statewide residential rate of $10.50 per month, the average rate in effect today. The $10.50 rate covers the cost of local residential service and provides a substantial contribution to shared and common costs.

Because USWC is overearning, the Commission is also ordering a number of rate decreases, for business rates, toll service, access service, and hunting service. This approach targets rate reductions to services where the rates are the most above incremental cost.[4] Bringing these rates closer to incremental cost should stimulate demand to the benefit of ratepayers and the Company.

C. Competition

USWC argues that it needs to meet existing and impending competition with sharply higher rates for residential customers, and lower rates for other, more competitive services. While higher local rates simply are not supported by the record in this proceeding, the Commission agrees that the Company needs pricing flexibility to respond to competition when it appears. As a result, the Commission is authorizing the Company to file banded rates for any

---

[4]Incremental costs of a single service do not include any shared or common costs that the Company is also entitled to recover. Overall, the Company's rates must be set above incremental cost to avoid unlawfully taking its property.

service it chooses. The rate set in this order will be the top end of the band. The Company may choose any level above incremental cost for the bottom of the band. Within that band USWC may change prices on ten days notice to customers and the Commission -- exactly the same notice as competitors are required to file. This flexibility gives the Company the ability to drop prices where competition requires, while restraining its ability to raise the rates of captive customers.[5] Of course, the Company is always free to propose increases in the rate caps if it can prove increased costs. The Commission retains jurisdiction to review the Company's use of banded rates to assure that they are not used in an improper manner or inconsistent with the terms of this Order.

D. Service Quality

The Commission finds that USWC is providing service that is substantially worse than that which the Company provided only a few years earlier, at the beginning of its AFOR.[6] The Commission's frequent and consistent attempts to achieve improvement in service quality have been unsuccessful. We find major problems with the Company's ability to install service when needed and its ability to provide repair service when needed, caused in part by lack of facilities and in part by restructuring and downsizing.

The Company's inability to meet its basic service obligations hurts individual ratepayers and it hurts the state economy as a whole. This Commission has not micro-managed USWC's re-engineering and restructuring efforts and does not intend to do so. We are concerned with results. To that end, we are ordering the Company to provide customer service guarantee programs and reducing the Company's return on equity by 0.5% to the low end of the reasonable range, to reflect the level of service it is providing and provide incentive for improvement. We also are ordering improved service quality statistics reporting, and disallowing management team and merit awards that are not clearly and directly linked to meeting service quality targets. When the Company can demonstrate that it is providing adequate service, it may petition to lift any or all of these requirements.

The Company has argued that it cannot invest in Washington state because of uncertainty about its future ability to recover its capital investment. Ex. 101-T, p. 13. The record

---

[5]The protection thus accorded captive customers will further the public policy goals enunciated by the Legislature in RCW 80.36.300, especially:

> "(4) Ensure that rates for noncompetitive telecommunications services do not subsidize the competitive ventures of regulated telecommunications companies[.]"

[6]It is unfortunate that the Commission's attempts to reduce the regulatory burdens on USWC appeared to result in the violation of one of the most important conditions for approving an AFOR, that it "[w]ill not result in a degradation of the quality or availability of efficient telecommunications services[.]" RCW 80.36.135(3)(e).

in the case demonstrates this to be unfounded. Under the AFOR (January 16, 1990 to December 31, 1994),[7] the Company was authorized to earn an attractive 11% rate of return, and it retained excess profits of $77 million. At the same time, it was cutting investment and reducing staffing levels in the state. Instead of re-investing its earnings in Washington State, the Company is generating funds by dis-investing in the state and failing to provide minimum levels of service to the harm of its citizens and economy. In this Order we authorize the Company to recover its proper costs of operating and to earn a market-based rate of return on its investment.

Our order does not give USWC all it wants. Instead it gives the Company what it needs: fair rates based on the Company's actual costs, greatly increased flexibility to lower prices to meet market requirements, and meaningful incentives to improve service quality.

PART TWO:

SCOPE OF PROCEEDING

HEARINGS: The Commission conducted seven days of public hearings to receive testimony from customers of the Company on the proposed rate increases in Port Angeles, Tacoma, Vancouver, Seattle, Yakima, Spokane, and Olympia. The Commission held sixteen days of evidentiary hearings in Olympia for receipt and cross-examination of testimony and exhibits of the parties to this proceeding. The hearings were held before Chairman Sharon L. Nelson, Commissioners Richard Hemstad and William R. Gillis, and Administrative Law Judges C. Robert Wallis and Terrence Stapleton.

APPEARANCES: USWC was represented by Edward T. Shaw, Molly Hastings, and Douglas N. Owens, attorneys, U S WEST, Inc., Seattle, and Sherilyn Peterson and James M. Van Nostrand, attorneys, Perkins Coie, Seattle; Staff of the Washington Utilities and Transportation Commission (Commission Staff) by Steven W. Smith and Gregory J. Trautman, Assistant Attorneys General, Olympia; Public Counsel by Robert Manifold and Donald T. Trotter, Assistant Attorneys General, Seattle; Washington Independent Telephone Association (WITA) by Richard Finnigan, attorney, Vandeberg Johnson & Gandara, Tacoma; GTE Northwest, Inc. (GTE), by Richard Potter, A. Timothy L. Williamson, and Timothy J. O'Connell, corporate counsel, Everett; PTI Communications, Inc. (PTI), by Calvin Simshaw, corporate counsel, Vancouver; Electric Lightwave, Inc. (ELI), by Ellen Deutsch, corporate counsel, Vancouver; AT&T of the Pacific Northwest, Inc. (AT&T), by Daniel Waggoner and Gregory Kopta, attorneys, Davis Wright Tremaine, Seattle, and Susan Proctor, attorney, AT&T,

---

[7]In the "AFOR" program, an alternate form of regulation that the Company and the Commission agreed to in 1990, the Company was freed of some regulatory constraints and allowed to earn and keep in excess of its authorized return in exchange for sharing excess earnings with customers as directed by the Commission. The customers' share largely was applied variously to refunds and to reduce accumulated depreciation.

Inc., Denver, Colorado; MCI Communications, Inc. (MCI), by Sue Weiske, corporate counsel, Denver, Colorado, Robert Nichols, Nichols & Hecht, LLC, Boulder, Colorado, and Clyde MacIver, attorney, Miller, Nash, Wiener, Hager & Carlsen, Seattle; Sprint Communications Company L.P. (Sprint) by Lesla Lehtonen, corporate counsel, San Mateo, California; Department of Information Services (DIS) by Roselyn Marcus, Assistant Attorney General, Olympia; Department of Social and Health Services (DSHS) by Leslie Birnbaum, Assistant Attorney General, Olympia; Department of Defense and Federal Executive Agencies (DOD\FEA) by Sheryl A. Butler, trial attorney, Arlington, Virginia; Enhanced Telemanagement, Inc. (ETI), by Gena Doyscher, external affairs director, Minneapolis, Minnesota; Northwest Payphone Association (NWPPA) and Metronet Service Corporation by Brooks Harlow, attorney, Miller, Nash, Wiener, Hager & Carlson, Seattle; American Association of Retired Persons (AARP) by Ronald L. Roseman, attorney, Evergreen Legal Services, Seattle; and, Telecommunications Ratepayers Association for Cost-based and Equitable Rates (TRACER) by Arthur A. Butler, attorney, Ater Wynne, Seattle.

Procedural History: On February 17, 1995, USWC filed with the Commission, under Advice No. 2617-T, revisions to its currently effective Tariffs WN U-30, -31,-32, with a stated effective date of March 21, 1995. The intended effect of the tariff revisions is an annual increase in the Company's revenue of approximately $95,301,836 for 1995; $22,602,847 for 1996; $46,785,542 for 1997; and $39,923,697 for 1998; the total annual revenue increase requested, phased in over a four year period, is approximately $204,613,922. On March 8, 1995, the Commission at its regularly-scheduled open public meeting suspended the operation of the tariff revisions pending hearings to determine whether the proposed tariff revisions are fair, just, reasonable, and sufficient.

A March 14, 1995 Notice of Hearing set a prehearing conference for April 6, 1995, at which time procedural aspects of the proceeding were determined, including invoking the discovery rule and establishing a schedule for prefiling and cross-examining testimony. The Commission entered a Protective Order governing the disclosure of proprietary and confidential information in this proceeding on April 24, 1995.

The Commission convened a prehearing conference on October 12, which was continued to October 17 and then to October 19, 1995, to receive oral argument on motions filed by USWC and Commission Staff. At the prehearing conference, USWC orally moved to continue the hearing schedule to permit the parties to engage in settlement discussions. The Company and Commission Staff believed that settlement of some or all issues was possible if the parties were given adequate opportunity to devote sufficient time and resources to mutually beneficial resolution of issues.

An October 19, 1995 Order of the Commission granted USWC's oral motion stating "[w]e continue to believe that those directly affected by the outcome of matters before the Commission are in the best position to protect their own interests through negotiation and alternatives to litigation." The Order was premised upon USWC's agreement to certain conditions which included proceeding with the public testimony hearing on service quality issues in Olympia on November 9; a deadline for filing stipulations or a settlement agreement; extending the statutory suspension period; and filing supplemental testimony on costing issues.

A January 4, 1996 Order of the Commission resolved the outstanding motions of USWC and Commission Staff. The Commission granted USWC's motions to compel AT&T to respond to data requests and to strike the testimony of AT&T witness Diane Toomey, but denied its requests to exclude certain issues raised by the Northwest Payphone Association and to exclude "yellow pages" revenue from this proceeding. The Commission granted the Staff motion to exclude certain depreciation changes from consideration.

The Commission conducted 16 days of evidentiary hearings, for cross-examination of prefiled testimony and exhibits of the parties, on November 9, 1995, re-convening January 8, 1996, and continuing for 15 days. The Commission was addressed by 52 expert witnesses, whose testimony required approximately 4,200 pages of transcript. The parties were permitted to file separate and simultaneous briefs on rate design issues by February 23, 1996, and revenue requirement issues by March 1, 1996; parties were allowed to file answering briefs no later than five days following each brief deadline. The Commission's Order is due not later than Friday, April 12, 1996.

Hearings for Public Participation. The Commission scheduled seven public hearings for receipt of testimony from members of the public as follows: Port Angeles on September 25; Tacoma on September 26; Vancouver on September 27; Seattle on September 28; Yakima and Spokane on October 2; and Olympia on November 9, 1995. The Commission was addressed by nearly 115 individuals and many more attended the hearings to express their position on this proceeding by virtue of their appearance.

The Commission had anticipated the many citizens who spoke in opposition to the level of the proposed rate increases, as well as the several who asked for fair treatment for the Company's needs. What the Commission did not expect was the huge outpouring of citizens decrying the poor service accorded them by USWC. These individuals related their experiences with USWC missing appointments for service installation, in some instances repeatedly, or the complete inability of USWC to deliver facilities to provide any service at all. Others described their experiences with extended delays in restoring service following an outage. Elsewhere in this Order we discuss service failures experienced by Internet entrepreneurs, large companies, and telecommunications company customers of USWC.

With either cause of poor service, customers were frustrated with their experiences attempting to contact USWC and seek information on the status of ordered service or reports of service outage. Many customers described the similar experience of phone calls to USWC being routed to different service centers in USWC's service area, sometimes during the same phone call but each time with multiple calls seeking assistance, from Minneapolis to Salt Lake City to Denver to Phoenix. And often they encountered service personnel who had no record of their service order or request for repair service, no information regarding the nature or cause of delays being experienced for either complaint, and who were themselves frustrated and simply unable to be of assistance.

USWC attended each public hearing with Company representatives from various operational areas who met after the hearings with individuals expressing service complaints.

PART THREE:

SERVICE QUALITY ISSUES

During the Commission's hearings for public testimony, conducted in seven cities around the State, customers repeated three themes time after time: the inability to get timely installation of service -- or in some instances, any service at all; delays experienced in getting service restored following an outage; and opposition to the magnitude of the proposed rate increase. The Commission scheduled a special hearing session to address customer service quality and sought information from top Company executives responsible for service.

This order segment begins with an overview of service quality problems in this state. It is followed by a discussion of the parties' recommendations on customer service issues and the Commission's decision.

I. Service Quality Problems

In January 1993, the Commission adopted rules establishing a minimum level of service quality to be observed by telecommunications companies providing service within this state[8]. These service quality standards and requisite service quality performance reports, when coupled with other service requirements of Chapter 480-120 WAC,[9] are designed to ensure all consumers of telecommunications services in this state timely installation and reasonable continuity of service, uniformity in the quality of service furnished, and safety of persons and property.

The Commission Staff became aware of a significant and disturbing trend in service quality degradation for the Company beginning in 1991. The number of informal service complaints reported to the Commission increased dramatically in the years 1992-1994, and

---

[8] On January 27, 1993, in Docket No. UT-921192, the Commission adopted WAC 480-120-500,-505,-510,-515,-520,-525, -530,-535; the rules were filed with the Code Reviser on February 26, 1993, and became effective on March 29, 1993.

[9] Included among the more pertinent rules in this regard are WAC 480-120-041, Availability of information; WAC 480-120-051, Availability of service--Application for and installation of service; and WAC 480-120-086, Adequacy of service.

appear to be escalating to an all-time high in 1995. These complaints largely address inability to obtain service in a timely manner, and undue delay in restoring service outages.

The Commission Staff during this timeframe, principally through the Commission's Consumer Affairs Section, diligently pursued not only resolution of individual complaints but also sought to gain the attention and support through ever-escalating levels of USWC's senior management in an attempt to reverse the trend. The Company constantly reassured Commission Staff, in meetings and in written communications, not only of its commitment to service quality, but of its intention to resolve permanently its service quality problems. Ex. 102-T, pp. 17-19; Ex. 107, 108, 109. The Company has been delinquent on both counts.

Commission Staff believes its attempts over the past several years to negotiate improvements in the Company's service quality informally and cooperatively have failed. It argues that the Commission must therefore take affirmative steps to address service quality issues, relieve the burdens on consumers engendered by poor service, and stimulate responses by the Company which will permanently resolve service quality problems in this state.

The Company's senior management has consistently pointed to unanticipated and unforecasted access line growth for its service quality problems. Ex. 107, 108. However, the testimony in this proceeding paints a picture of causes deeply-rooted in USWC's re-engineering and restructuring efforts aimed at reducing costs (Ex. 102-T. pp. 16-17), and reduced investment in Washington State infrastructure improvements (Ex. 101-T, p. 13, 11. 16-20).

USWC has undertaken simultaneously a massive re-engineering and restructuring program to revamp and consolidate operations and reduce costs. The re-engineering effort involves the design and implementation of new computer-aided systems and programs, replacing paper and manual handling of information, to increase efficiency and create opportunities to enhance productivity and expand the number of functions performable by one employee during a single customer contact.

This re-engineering effort included the consolidation of service centers. This consolidation resulted in significant reductions in this state of personnel familiar with the intrastate network and facilities -- a 30% reduction in engineering staff in Washington in just two years (TR 1007). The Company experienced significant errors when paper records containing faulty inventory of facilities were manually posted to electronic databases in the new systems; Washington State records at the time of entry into the new databases were apparently poorer than average, which the Company hopes to resolve in mid-to-late-1996. (TR 1007). Finally, these new computerized systems, while a significant technological leap over former manual systems, were intended to be a transitional step toward an even more automated engineering tool. Unfortunately, this more sophisticated tool was to come on-line in third quarter 1995, but its complexity was so overwhelming the Company now projects an on-line date no earlier than sometime in 1997. (TR 1029-1030).

The Commission believes the Company's restructuring and re-engineering efforts may well be appropriate in an emerging competitive environment. USWC has made tough decisions and moved decisively to implement those decisions. The transition has been difficult for all concerned -- the dislocated employees, the management struggling to bring new systems and programs on-line with little lead time, the employees attempting to master the re-engineered systems, at times with incorrect or inadequate information available to them, and in some instances without sufficient training, and the customers experiencing newly re-trained employees who with their inability to use the new systems successfully are as frustrated as the customers who are getting no satisfactory resolution of their problems.

USWC's Washington Vice President Dennis Okamoto admits that the Company's re-engineering effort has contributed to service quality problems. (TR 717-718). He also acknowledges that its employees are still on the "learning curve" in terms of mastering the newly re-engineered systems, and that process may take up to another year to complete. (TR 714-716).

The Commission expects, as Company witnesses represented, that once the "bugs" are eliminated, all systems are available, installed, operational, and in the hands of a qualified and trained work force, USWC will provide and its customers will experience the level of service to which they are entitled. The improvement however has yet to materialize.

The fact remains that USWC has failed to meet its minimum service obligations, failed in dramatic and painful ways for all classes of its customers, and failed increasingly, year after year.

USWC witness Dennis Okamoto testified that a hostile capital structure and capital recovery environment in this state has led the Company to reduce its Washington investment, and has led in turn to shortages of necessary facilities.[10] The record confirms that the Company's capital investment has fallen in Washington and continues to lag 1992 levels. The record shows that the Company earned a return of up to or exceeding 11% during the five years of its alternative form of regulation (AFOR) and kept over $77 million in excess earnings. The record also shows that the Company was significantly reducing its capital investment in this state during those same years.

Commission Staff notes the Company's Form M Annual Report to shows that new investment per year in Washington declined from $354 million in 1992 to $268 million in 1994, a decline of $86 million. Ex. 125-T, pp. 9-10. USWC witness Okamoto testified that the

---

[10] Mr. Okamoto, in response to questions from AT&T, acknowledged that internal competition for funds for capital investment purposes is keen, and that the payment of 100% of its dividend to the parent company, U S WEST, Inc., has resulted in substantial investment overseas and domestically outside its service territory. Mr. Okamoto asserted that "[t]he shareholders demand that managers of the business invest the capital dollars appropriately and where they can get the best returns[.]" (TR 729-732).

Company likely will have spent over $330 million on capital expenditures in Washington in 1995. TR 550. This level still represents a decline over 1992 investment, before accounting for inflation. The same Form M shows that depreciation expense has increased from $226 million in 1992 to $301 million in 1994, a $75 million increase. Ex. 125-T, p. 9. To the date of filing of its testimony in this case, Staff notes the Commission has authorized in 1995 additional adjustments to the normal depreciation reserve accruals of more than $30 million.

II. Held Orders and Service Interruptions

A. Complaint Levels

Commission Staff presented a study quantifying the number of informal service complaints being filed against USWC, and the number of resulting Commission rule violations from held order and service interruption complaints.

When compared to other local exchange companies (LECs) in the 1989-1994 time period, USWC's growth in access lines was comparable to other LECs only in 1991, and was less than other LECs for the remaining years in the study period. In all years but 1989 and 1990, USWC service complaints and rule violations per 100,000 access lines far exceeded those of other LECs. The Company did not substantiate its representations that growth is the root cause of its service quality problems. Ex. 103, 104, 105. Likewise, when compared only to itself in the 1989-1994 time period, USWC service-related complaints and rule violations show dramatic growth, indicating not only service quality deterioration, but continuing deterioration of unprecedented scale. Ex. 106.

Several exhibits illustrating trends in service quality identified in the Commission Staff study are reproduced in this order.[11]

In January 1995, Mr. Okamoto committed to corrective actions aimed at eliminating held orders and service interruption violations by April 1, 1995, reducing total 1995 complaints by 30% over 1994 levels, and reducing total 1995 rule violations by 75% in 1995. The Company showed some improvement between January and April 1995, but in May through August 1995, both total numbers of complaints and rule violations increased substantially. Ex. 110, 111, 112, 113. As of August 1995, held order and service interruption complaints were at their highest level and were continuing to increase rather than decline. Ex. 102-T, p. 21.

---

[11] Four of the exhibits are labelled "Rule Violations." However, this assessment is based upon Staff's analysis of recorded complaints, and does not represent a determination by the Commission after notice and an opportunity for hearing, that USWC has violated the Commission's rules.

B. Rule Violations

Service quality complaints involving held orders and service interruptions largely reflect violations of two Commission rules. WAC 480-120-051 requires that if, prior to an agreed-upon date for installation of service, it becomes apparent that service cannot be installed as agreed, a company shall promptly notify an applicant of the delay and the reasons. Commission Staff reports a significant increase in the number of informal complaints where applicants are provided in-service dates by USWC, the installation is not completed as agreed, and applicants are given no notice that the date will be missed nor an explanation why the installation was missed.

WAC 480-20-520 requires that all reported interruptions of service shall be restored within two working days, except interruptions caused by emergency situations, unavoidable catastrophes, and force majeure. Again, Commission Staff notes significant increases in the number of informal complaints regarding restoration of service in the required timeframe. Based upon customer complaints and Company responses to informal service complaints, Staff believes failure to meet installation and repair obligations is due primarily to reductions in technical and engineering work force. Ex. 102-T, p. 15.

A majority of those testifying at public hearings around the state related personal experiences with poor service quality -- repeatedly delayed installation of new service, often without prior notice, and unreasonably delayed restoration of service outages. This testimony tracks the nature of the service complaints received by the Commission during the preceding four years.

C. Recommendations Addressing Service Quality Problems

A disagreement exists between the Company and Commission Staff over what constitutes a "held order" resulting in a rule violation. WAC 480-120-051(1) and (2) prescribe for all local exchange companies the explicit conditions for the installation of primary exchange access lines.[12]

---

[12] WAC 480-120-051 reads in part as follows:

(1) As measured on a calendar monthly basis, ninety percent of a local exchange company's applications for installation of up to five residence or business primary exchange access lines in any exchange shall be completed within five business days after the date of receipt of the applications when all tariff requirements have been met by the applicant or subscriber. In those instances where a later installation date is requested by the applicant or subscriber or where special equipment or service is involved, this time period does not apply.

(2) Ninety-nine percent of all applications for installation of primary exchange access lines in any exchange shall be completed within ninety days after the date of receipt of the

First, under its system of record-keeping, the Company reports to the Commission the monthly total of orders held at a given point in time. The Company asserts that once an order is completed the record is deleted. The information is not reported in a detail that permits Commission Staff to determine the length of time any individual order was held by the Company. Thus, Staff cannot determine, for example, that in a January 31 report of 200 held orders the Company also had 700 held orders between January 1 and January 29 that were held longer than five working days but completed prior to the reporting date. Second, it is the Company's position that "primary exchange access" involves only the first line into a premise and that additional lines are not covered by the rule, despite the rule's clear directive that "up to five residence or business primary exchange access lines in any exchange shall be completed within five business days" when all other conditions of the rule are satisfied.

Commission Staff recommends that the Commission require USWC to provide monthly service order reports which, at a minimum, include the following information by exchange by class of service:

> The number of all orders for primary exchange access lines received in a given month;
>
> The total number of orders held beyond five business days, identifying the number not requiring special equipment or service and the number requesting a later in-service date; and,
>
> The cumulative reporting of all held orders until service is installed and in working condition.

The Commission will order the record-keeping and reporting requirements recommended by Commission Staff. These measures will provide information sufficient to permit verification of compliance with WAC 480-120-051 and afford the Commission the opportunity to pursue enforcement for violations of that rule.

Commission Staff witness Spinks recommended that the Commission order USWC to provide customers with cellular phone service when ordinary service cannot be provided within 30 days. Specifically, if customers are required to wait more than 30 days for service over Company facilities, the customer would be provided with cellular service, using a carrier of the customer's choice, at the same rate the customer would pay for the Company's service. The Company would pay the difference up to $150 in cellular service per month.

In its response to Bench Request No. 13, filed on February 12, 1996, USWC informed the Commission that it had recently introduced a service guarantee program throughout its 14 state service area. The program includes:

---

applications when all tariff requirements have been met by the applicant or subscriber.

1. Service orders held over five business days, but less than 30 calendar days, will receive an installation credit of $31.00; the customer will also be offered at no cost a Market Expansion Line/Remote Call Forwarding service which includes assignment of the new telephone number, a USWC calling card, and a directory listing;

2. For service orders held more than 30 calendar days, Washington customers will receive either a credit for Basic Exchange Service of $10.75 for month or partial month the order is held, **or** a cellular subsidy payment of $105.00 for the first month and $75.00 for each additional month.

The Company indicated it would begin offering the new service guarantee program in Washington on March 5, 1996.

The Commission will order implementation of a customer service guarantee program along the lines of that voluntarily proposed by the Company, but with modifications, to be effective immediately. Specifically, the program will include the following until modified or discontinued by Commission order:

1. For service orders for up to one residential and two business primary exchange access lines in any exchange not completed within five business days: USWC will waive installation charges, and credit the basic monthly rate; provide at no cost Market Expansion Line\Remote Call Forwarding service which includes assignment of a telephone number, a USWC calling card, and a directory listing; and

2. For service orders for up to one residential and two business primary exchange access lines in any exchange not completed within 30 calendar days: USWC will offer a subsidy payment for cellular service at the rate of up to $150.00, less the recurring monthly rate for the local exchange service, for each month or partial month the order is held (and provide a cellular telephone) **or** voice messaging service **or** paging service **or** remote call forwarding service at the customer's option.

III. Other Service Failures

A. Large Customers

TRACER witness Bookey recounted service problems experienced by six large USWC customers, mostly relating to provisioning of new digital facilities which he claims generally takes from three to six months, but in many instances as long as one year. These customers range from Fred Meyer Stores, which claims every retail store in USWC's service territory has had significant problems, to the University of Washington which reports major problems with 1) trouble reporting, 2) service order processing, 3) ISDN and high capacity service provisioning, and 4) engineering. As troubling as the delay itself, for many of these customers, is communicating with USWC service personnel who are described as frustrated and inexperienced, who are frequently rude, and either fail to call back or leave customers on hold for long periods.

The placement of trouble calls to USWC which used to take a few minutes now may take from 1/2-hour to days. Inexperienced customer service staff lack sufficient technical knowledge to input trouble reports properly, resulting in faulty and insufficient information in USWC's trouble ticket tracking system. When engineering staff discover inadequate or inaccurate information, trouble tickets are closed and reported as a customer problem, requiring customers to re-start the whole process with a new trouble report.

B. Internet Service Providers

The Commission held hearings in seven cities around the state, and in all but two cities the Commission heard from entrepreneurs attempting to launch or expand Internet service provisioning businesses. Their experiences with obtaining Integrated Services Digital Network (ISDN), T-1 services, and other relevant services and assistance from USWC were varied, but all were unsatisfactory. The Company informed an applicant in Port Angeles that ISDN service would not be available in the immediate future, if ever; while in Vancouver an applicant who was told facilities and services were available to serve his proposed business location was denied facilities and service for so long that his venture capital had been exhausted and he faced the prospect of bankruptcy, having never been connected to the network at the location from which USWC had guaranteed its network was capable of serving his needs.

The Commission heard similar stories of requests for ISDN and T-1 service being met with indifference and delay in each of the other cities where Internet service providers testified. The similarity of experience of such entrepreneurs in all corners of the state from Port Angeles to Yakima, from Vancouver to Seattle, and the similarity of complaints about USWC's treatment of subscribers and attitude toward this growing segment of the economy is as disturbing as the Company's held orders and rule violations.

The Company's apparent indifference and the undue delay experienced by these start-up enterprises left one Internet service provider at the Olympia public hearing to speculate whether USWC was intentionally repressing growth of new Internet service providers in anticipation of USWC's own entry into this line of business. USWC witness Okamoto, in response to a question from Commissioner Hemstad, indicated the Company would launch its Internet service in six-to-nine months, but anticipated no facilities problems with the Company's own service. (TR 755). Chairman Nelson queried Mr. Okamoto for his reaction to the public witness' speculation about motive, and was told the Company was experiencing trouble providing high capacity services to everybody, and the Internet providers have simply been caught in this service failure. (TR 770).

C. Telecommunications' Company Customers

The telecommunications company customers of USWC also presented testimony on the deteriorating quality of the Company's services. AT&T provided testimony on two standard measures of performance -- on-time delivery and circuit failure rate -- for special access, which it characterizes as the most readily quantifiable services to provide. Comparing USWC with the other six Regional Operating Companies (ROCs), the best service provisioner met installation deadlines 99-100% of the time, depending upon the discrete service, while USWC met its commitments 74-94% of the time, again depending upon the service. AT&T "footnotes" its statistics, first by noting USWC's steadily declining performance during 1995, and second by commenting that where other providers may miss a delivery date by a day or two, USWC misses by weeks, even months. In some instances, AT&T requests for service in January-February 1995 had not been completed in August when its testimony was filed.

AT&T suggests a fully competitive market is the best solution to service quality problems, arguing performance standards and service quality reporting serve only to quantify not resolve problems.

Electric Lightwave, Inc. (ELI) complained of six general problem areas with USWC service provisioning: (1) use of a single account representative, despite its growing volume and complexity of service needs; (2) slow entry, sometimes up to days or even weeks, of ELI orders into USWC's computerized service order entry systems; (3) insufficient experienced personnel to complete installations on a timely basis; (4) inaccurate or incomplete facilities database and physical installation problems; (5) service order tracking and status and update reporting; (6) inability to engage in cooperative joint testing and failure to notify of completion of installation.

ELI requests the Commission order USWC to modify its tariffs to provide service credits for all delayed service order installations.

The Commission will order USWC to implement a program of service credits for all delayed service orders. We agree with ELI that, like the service guarantee program ordered above for customers of residence and business primary exchange access lines, the specialized business customers and telecommunications company customers of USWC are entitled to reasonable service order installation guarantees.

The Commission therefore will order USWC to implement the following service guarantee program for all service order installations other than primary exchange access lines, to be effective immediately, until modified or discontinued by Commission order:

1. For all mutually agreed upon installation dates for which service is not completed as ordered, or the ordering party is either not notified the service is completed within 24 hours of installation or the new date for the rescheduled installation prior to actual installation, USWC will waive all non-recurring charges for the service/s to be installed; and

2. For every three week period and partial period of up to three weeks (i.e. 1-3 weeks; 4-6 weeks; 7-9 weeks; etc.) the ordered service/s is/are delayed, USWC will waive one month's recurring monthly charge for the service/s to be installed.

IV. Revenue Requirement Adjustments

A. Lost Revenue Adjustment

Staff witness Beaton recommends an adjustment, as shown in Ex. 704, MLT-5, for held orders during the test period; the amount of this adjustment is calculated using average residential and business bills as demonstrated in Ex. 605-C. The adjustment increases test year revenue by $510,241 and net operating by $325,593. Ex. 114-T, p. 24. The adjustment is premised upon the assumption that, had the Company not experienced extraordinarily high levels of held orders during the test year, services would have been installed and generating revenue for the Company.

USWC contests the adjustment. USWC witness Okamoto contends that the Company currently meets minimum service quality requirements. Additionally, he contends that a revenue reduction of $0.5 million further depresses funding of new infrastructure deployment in Washington. Ex. 101-T, p. 7.

The Commission rejects the adjustment proposed by Staff. The current status of record-keeping and reporting of held orders makes it difficult to accept with confidence the link between an average month's held order number and loss of specific revenue. In addition, Ms. Beaton does not offset asserted revenues with the costs associated with providing service.

B. Team and Merit Awards

Ms. Beaton also proposes disallowance of part of the incentive pay associated with the Company's Team and Merit Awards program. Specifically, she recommends disallowance of that portion of the program for Customer Service Measurement (CSM) amounting to a \$1.3 million reduction in test year salary expense as shown in Ex. 670-C, RSA-13. The adjustment is premised upon poor customer service related to deterioration in overall levels of service quality.

The Commission's treatment of the Company's Team and Merit Award program is discussed in specific detail in the revenue requirements section of this order.

C. Management Salary Increase

Staff witness Spinks proposes to disallow recovery of test year and pro forma management salary increases. Ex. 602-T, pp. 18-19. The adjustment as shown in Ex. 730-C, MLT-25, would reduce salary expense by \$7.6 million in recognition of the failure of Company management to provide an adequate level of service quality. Mr. Spinks contends that the Commission could provide an incentive to the Company to provide better levels of service by allowing it to seek increased rates to recover salary increases once it demonstrates that service has improved.

The Commission believes that the suggested adjustment is not sufficiently related to the problem it is asserted to address. We therefore will not make this adjustment, in favor of incentives aimed at the specific problem and designed to motivate the Company to address and improve service quality.

D. Equity Return Adjustment

Finally, Mr. Spinks recommends that the Commission adopt a return on equity at the low end of the range of reasonableness found appropriate by the Commission. He states that the Company, Commission Staff, and Public Counsel have testified to a range of return on equity which represents the bounds of reasonableness on the overall cost of common equity for the Company. Once the Commission establishes the appropriate equity return range of reasonableness, he urges that the Commission establish a return at the low point of the range in recognition of the service quality degradation plaguing the Company and its customers. Ex. 602-T, pp. 17-18.

USWC opposes any Commission action in response to the Company's service quality problems. Mr. Okamoto contends that, while the Company's high service standards have slipped during its restructuring "to meet the reality and dynamics of a fully competitive environment," it continues to meet minimum standards. Therefore, no "performance penalties" in terms of a rate of return adjustment are appropriate, especially where competitors are not held to the same standards. Ex. 101-T, p. 15.

The Commission has held, in other instances, that it may review service quality in setting a public service company's rate of return. The Commission in WUTC v. Alderton-McMillin Water System, Inc.,[13] found that the level, scope, and on-going nature of the company's management and service quality problems argued for a return on equity less than would be appropriate for a company providing adequate service. The Oregon Public Utility Commissioner after noting complaints regarding substandard service, unreasonable delays in disposing of out-of-service reports, and other service related problems established a telephone company's rate of return in the lower ranges of the zone of reasonableness.[14] Other state public utility commissions and courts have also held that service quality may be considered in setting a reasonable return on equity.[15]

The Commission will adopt the Staff recommendation with regard to the authorized return on equity, not as a penalty but as an incentive to improve customer service. The Commission expected Company management to meet its commitment to resolve its service quality problems, and refrained from instituting proceedings and levying fines as service quality continued to deteriorate. However, the Company has shown no willingness or ability to bring an end to its customer service problems, and our patience is at end. The rate case consideration of service quality in setting a return on equity at the lower end of the range of reasonableness is a well-established regulatory response to documented abuse of a Company's public service obligation.

Commission Staff suggests, and we agree, that the Company may petition to have its authorized equity return adjusted to midrange, and to have revenue requirement adjusted to reflect the amount of the adjustment in this order. The Company will be expected to demonstrate that its service quality in terms of held orders, in terms of missed or incomplete appointments, in terms of repair service in compliance with rule, and in terms of customer complaints to the Commission, all have returned to and remain stable at levels comparable with the Company's experience prior to 1991 and consistent with other local exchange companies

---

13 Third Supplemental Order, Docket No. UW-911041, August 31, 1992.

14 Re West Coast Teleph. Co., 27 PUR 3d (Oregon, 1958).

15 Re General Telephone Co. of Ohio, 68 PUR4th 212 (Ohio, 1985); Re Norfolk & Carolina Tel. & Tel., 18 PUR4th 592 (N. Carolina, 1977); Re South Cy. Gas Co., 53 PUR4th 525 (Vermont, 1983); Pet. of Young's Community TV Corp., 442 A.2d 1311 (Vt., 1982).

within the State. The petition will be particularly persuasive if Commission Staff and Public Counsel join in it.

The determination of the capital structure and the equity return component are discussed in specific detail below. This adjustment decreases revenue requirement by $6.5 million.

PART FOUR:

RESULTS OF OPERATION

The parties propose, and the Commission accepts, that the period beginning November 1, 1993 and ending October 31, 1994 be used as a test period for examining the Company's operations. It is the latest period for which information has been available throughout the preparation for and processing of this proceeding. It has been used by all parties as the basis for their analyses of the Company's performance and condition.

In accepting this test period, the Commission does not find that the relationships that existed during the period are necessarily representative of the future. The Commission considers in this order a number of adjustments that parties suggest to make the test period more representative of future relationships. The Commission finds that the 12 months ending October 31, 1994, is the appropriate test period for examination of the Company's operations for purposes of this proceeding.

The Company starts with a portrayal of its operations and its property during the test year in Exhibit 198. The Commission finds that the Exhibit 198 sufficiently reflects the Company's actual property and operations during the test year to be regarded as the appropriate starting point for regulatory analysis. It should therefore be accepted for purposes of this Order.

Numerous adjustments are proposed, and matters presented for analysis. We group those[16] in the areas of adjustments to revenues, to operating expenses, those regarding affiliated transactions, taxes; rate base, and determination of rate of return. In each discussion we identify our decision's effect on rate base and operating results. At the conclusion of this Part of the order, we display the results in tabular form to identify the major components of ratemaking analysis: revenue requirement equals the authorized rate of return times rate base, plus operating expense.

---

[16] We follow the outline of issues prepared by the parties. The Commission commends the parties, especially the Company, Public Counsel, and Commission Staff, for producing the agreed outline. The outline has assisted the parties in making effective presentations and assisted the Commission in the thorough and careful consideration of parties' presentations.

I. Legal Standards

The ultimate determination to be made by the Commission in this matter regarding the Company's rates and charges is whether the rates and charges proposed in revised tariffs are fair, just, reasonable, and sufficient, pursuant to RCW 80.28.020. These questions are resolved by establishing the fair value of respondent's property in-service for intrastate service in the State of Washington, determining the Washington intrastate adjusted results of operations during the test year, determining the proper rate of return permitted respondent on that property, and then ascertaining the appropriate spread of rates charged various customers to recover that return.

The purpose of a rate proceeding is to develop evidence from which the Commission may determine the following:

1. The appropriate test period, which is defined here as the most recent 12-month period for which income statements and balance sheets are available. The test period is used for investigation of the Company's operations for the purposes of this proceeding;

2. The Company's results of operations for the appropriate test period, adjusted for unusual events during the test period, and for known and measurable events;

3. The appropriate rate base, which is derived from the balance sheets of the test period. The rate base represents the net book value of assets provided by investors' funds which are used and useful in providing utility service to the public;

4. The appropriate rate of return the Company is authorized to earn on the rate base established by the Commission;

5. Any existing revenue excess or deficiency; and

6. The allocation of the rate increase or decrease, if any, fairly and equitably among the Company's ratepayers.

RCW 80.04.130 places the burden of proving that a proposed increase is just and reasonable on the public service company proposing such an increase.

II. Revenues

The Commission's first task in examining results of operation is to determine the Company's adjusted revenues for the test period.

USWC's exhibit 198 reflects its actual revenues for the test period, separated for Washington intrastate jurisdictional operations. Three adjustments are contested: one to give effect to a Commission-ordered rate reduction after the test year; one to impute revenues of the Company's prior Yellow Page operations; and one to reflect service quality concerns. Other decisions affect revenues and will be discussed in appropriate segments of the Order.

A. Revenue Levels RSA-3, C-1[17]

The Company proposes adjustment RSA-3 to reflect a rate reduction that the Commission ordered in 1994, during the test period. Commission Staff witness Twitchell accepts the Company's adjustment, and makes changes only to give effect to taxes and fees on the pro forma revenues. The Company accepts Mr. Twitchell's revisions.

Public Counsel witness, Mr. Brosch, contends that adjustment RSA-3 to reduce local revenues is an inappropriate pro forma adjustment because it does not consider offsetting factors. He contends that increasing revenues more than compensate for the decreased rates. Mr. Brosch proposes adjustment C-1, which would increase local exchange revenues to an annualized level based on the fourth quarter of 1994 rather than the adjusted test year figure.

The Company responds, through Ms. Wright, that Public Counsel's adjustment is inappropriate. She states that the Company's proposed adjustments to revenue are consistent with prior Commission orders and that his adjustment is one sided, pointing out that the adjustment does not annualize toll revenue, which she contends has shown a decline.

Mr. Brosch finds no reason to further adjust toll and access revenues. He indicates that the primary toll carrier and sale of rural exchanges adjustments are appropriate and that they properly adjust the toll access revenues. He points out also that the Company's rate base is declining and that use of an average figure -- which he does not propose to change -- operates to the Company's advantage.

The Commission finds that Mr. Brosch is most credible in his analysis and that the revenue portrayal with his adjustment most accurately reflects the Company's ongoing operations. The Commission agrees with Mr. Brosch that the use of the test year has to be balanced. The Commission cannot take one event, the rate reduction, out of the context of what is happening in the entire operation. That is the purpose of a general rate proceeding. It is our primary duty to look at relationships among revenues, costs, and rate base as they relate to the future. Ms. Wright's presentation does not reflect the Company's shrinking rate base. To the

---

[17] The numbers following each heading refer to the adjustments that are discussed in the following section. The adjustments are shown both on the appended comparison table and on the Commission's table of results of operation and rate base following the discussion of rate base.

extent that toll revenues are dropping, the Company did not submit an adjustment to reflect that, and the falling rate base will tend to ameliorate it. The Commission reasons that, therefore, Public Counsel's position should be adopted and both adjustments accepted.

B. Yellow Page Imputation, SA-1 and C-3.

Before 1984, Pacific Northwest Bell, the predecessor in Washington State of US WEST Communications, Inc., published its own telephone directory, including Yellow Pages.[18] Ex. 390-T, p.16. The publishing revenues and expenses were a part of the Company's results of operation for regulatory purposes and constituted a regulatory asset of the Company. Effective January 1, 1984, directory publishing was placed in Landmark Publishing Company. The publisher is now US WEST Direct (USWD), a division of US WEST Marketing Resources Group, Inc. (MRG). Between 1984 and 1988, the affiliated directory publisher paid annual publishing fees to USWC, ranging in amount from $14.9 million to $40.5 million. The payments ceased after 1988, according to USWC, " . . . because USWC recognized that there was no operational or business need for a cash payment to flow between the two US WEST companies." There is no indication that PNB or USWC received compensation other than the publishing fee for the transfer of the directory business or that it received compensation for the termination of the publishing fee. USWD is the exclusive publisher of directories for USWC, which provides billing and collection services exclusively to it.[19]

In the Second Supplemental Order, Cause No. U-86-156, the Commission treated the Directory as a regulatory asset and determined that the public interest requires the full reasonable value of directory publishing be available to PNB for ratemaking purposes. It found that the then-current publishing fee was not determined in an arms-length transaction with each party seeking to maximize return, but deferred adjusting the value until a later time.[20]

As a condition to the merger of PNB into USWC, all of the parties including USWC agreed in a signed stipulation, presented to the Commission and approved, that if the merger were approved, Yellow Page revenues would be considered as though the merger had not

---

[18] For convenience, because USWC is the successor to PNB and USWD and MRG the successor to Landmark, references using the current company's name shall be deemed to include the predecessor entity if required in context because of the timing of events, and references to MRG or USWD are interchangeable unless required by the context.

[19] USWD also publishes one directory for customers in the Washington State territory of one other Company.

[20] The Company argues that this order did not become final for procedural reasons involving the settlement of litigation. Whether or not we treat the order as "precedential," we believe that it expresses a sound analysis and we accept and adopt the analysis as having continuing validity.

taken place.[21] The order provided that the Commission could modify the arrangement by a future order. The Alternative Form of Regulation (AFOR) agreement between the Commission and the Company in 1990 contained an implicit directory imputation calculation.

US WEST opposes the revenue imputation. The Company did provide a calculation consistent with the order in U-89-2698-F and U-89-3245-P. The Company calculation yielded an adjustment which would increase operating income by $49.2 million. Staff witness, Ms. Strain, accepts the method used by the Company but adjusts the inputs to Staff's level for rate of return and net-to-gross multiplier. Her results would increase net operating income by $50.6 million.

Dr. Selwyn for Commission Staff recommends that yellow page revenues be allocated at $4.27 per residential line per month to lower residential rates. He also argues that, because Yellow Page imputations are intended to subsidize residential service, not USWC's competitive advantage, and because alternative local operating companies (ALECs) may be able to take the operating revenues such as toll, but will not be able to dent USWC control of directory revenues, the Yellow Page subsidy should be portable with the residential customer. He does not explain how this portability would work.

Public counsel's witness, Mr. Brosch, proposes a revenue imputation approximately $3.5 million larger at the NOI level than Commission Staff's. Public Counsel/TRACER calculate the appropriate contribution at $4.76 per residential line, per month.

Ms. Koehler-Christensen presented USWC rebuttal. Her testimony identifies the level of contribution in current rates as $2.29 per line per month.

We are not convinced that Mr. Brosch's method is more accurate, but believe that his approach to the calculation may have merit for the future. The Commission does believe that revenues earned in the State of Washington should be allocated to the State of Washington. The Commission will reject Mr. Brosch's calculation in this proceeding, however, because of concerns that amounts may be inaccurate.

The Commission finds that the Commission Staff method of calculating the adjustment is proper. It is simpler and is more directly tied to the Company's information. Because the imputation depends on rate of return, we have recalculated it using the accepted rate of return. The resulting dollar value of the adjustment is $50,934,378 at the net operating income (NOI) level.

The Company repeats many arguments in its brief that it raised, and the

---

[21] The settlement agreement reads in part as follows:

6. <u>Directory</u>. A. USWC agrees that the fact of the merger has no legal impact whatsoever on the issue of imputation of revenues to USWC for directory advertising. * * *

Commission rejected, at the outset of the hearing when the Commission rejected the Company's motions to remove yellow page advertising revenues from consideration as a matter of law. The Company also raises some new arguments. The Company cites no Commission or court decision in any USWC jurisdiction or in any other jurisdiction that specifically accepts any argument that USWC presents, but notes on reply that a Wyoming statute now forbids imputation.

The Company's arguments are as follows:

1. The Company argues that the advertising revenues are not earned by USWC, which has transferred the directory publication to an affiliated company. These are nonregulated revenues, it argues, and not only may the Commission not consider them, it exceeds its statutory authority and commits a dire constitutional violation by attempting to do so. It argues that the Commission does not seek to seize the revenues of other nonaffiliated publishers, and therefore, taking the USWD revenues is improper and discriminatory. USWC has no more access to its affiliate's revenues, USWC argues, than to revenues of nonaffiliated publishers. It stresses that the revenues are not for telecommunications services, which the Commission does have the power to regulate.

The Commission rejects this argument. There is no seizure of revenues, which are at all times entirely under the control of the affiliate and are never used or directed by the Commission. Instead, for regulatory purposes in calculating performance, the Commission imputes the "excess" revenues to USWC results of operation. The Company agreed that the merger would have no effect on imputation. The Commission finds the directory publishing business to be a regulatory asset. Commissions have historically been authorized to impute revenues from interrelated operations that have been transferred to affiliates, to prevent utilities from taking profitable aspects and leaving captive utility customers with expenses of the operation but with reduced offsetting revenues from related services.

2. The company argues that, under the decision in POWER v. WUTC, 104 Wn.2d 798, 711 P.2d 319 (1985), the allowable ratemaking formula is that the revenue requirement equals operating expenses plus the product of the rate of return times the rate base. Because affiliates' incomes are not any of those elements, says the Company, they may not be considered in ratemaking.

The Commission rejects this argument. The POWER decision does not forbid proper and lawful ratemaking adjustments in deriving the levels of expense, rate base, or rate of return. Neither does it forbid reasonable and lawful adjustments in calculating the Company's test period revenues -- a sum that is necessary in order to determine either the excess revenues or the revenue deficiency that must be met through rates to allow the Company to achieve its revenue requirement.

3. USWC argues that a regulated utility has the right to conduct a nonregulated business. The Company cites several Supreme Court cases from the early years of the twentieth century in support of its argument, and contends that the proposal to impute yellow page revenues would violate that right.

The Commission does not disagree with the proposition that a regulated utility has the right to conduct a nonregulated business. The proposed imputation does not interfere with USWC's right to conduct any business it wants, nor does it interfere with its affiliate's right to conduct any business. The USWC citations are irrelevant to the circumstances.

4. The Company argues that Wash. Const. Art. XII, Sec. 19 declares that telephone companies are common carriers and subject to regulation. It contends that the proposal regulates advertising, and notes that advertising is not included as a business subject to regulation under the Constitution.

The Commission rejects this argument. The Commission exercises no jurisdiction over advertising, which is not regulated in any way by this proposal. Only the utility is regulated or affected, pursuant to statutory and Constitutional authority .

5. The Company argues that RCW 80.04.270 forbids the Commission from considering revenues from the sale of merchandise as part of a regulated company's operating revenues. Although US WEST argues that merchandise is not defined in the statute, it argues that printed advertisements are clearly merchandise and within the terms of the statute.

The Commission rejects this argument. Merchandise includes all goods which merchants usually buy and sell.[22] US WEST Direct is not a printing job shop, and the advertiser is not purchasing any goods of any kind. The Commission finds that the advertiser is purchasing the service of having advertisements printed and distributed to every telephone subscriber. The advertiser has no property right in any printing, printed advertisements, or other physical property as a result of the advertisement. Thus there is no sale of merchandise, and the statute is inapplicable.

6. The Company argues that the Commission's general power to regulate in the public interest or to approve affiliate contracts does not authorize imputation.

The Commission rejects this argument. The issue here is not contract approval; it is accounting for income and expenses and assigning responsibility for the reasonable operation of the utility and the Company's dealing with a regulatory asset. The Commission clearly has authority to do that under its power to regulate in the public interest.

7. USWC argues that the company has not acquiesced or waived its rights. There was no rate case, prosecuted to conclusion, in which imputation was an issue. The order in U-86-156 was appealed but dismissed upon the agreement of both parties that the orders were not final. No settlement temporarily acquiescing in imputation can be used as a waiver.

---

22 Black's Law Dictionary, 5th Ed. (1979), at 890.

Whether or not the Company waived its rights, it has accepted imputation as an element of the AFOR. The dismissal of the order in U-86-156 does not diminish the force of the Commission's logic and the correctness of its analysis.

8. USWC argues that under the Telecom Act, universal service may only be subsidized on an equitable and nondiscriminatory basis, and imputing income to USWC is improper because there is no evidence subsidies are needed by all customers including those who may be millionaires.

The Commission rejects this argument. The proposal is not a universal service subsidy. It is a ratemaking adjustment. Its purpose is to reflect funds that would be available to the Company, but for Company action. In any event, the Commission finds in this Order that existing rates for local exchange service do cover incremental costs of providing that service, which thus needs no "subsidy", and the Commission does not attribute or "earmark" the directory imputation directly to any class of customers. Therefore the subsidy argument is inapposite.

9. USWC argues that the Commission cannot explore whether USWC acted reasonably in transferring the directory because management decisions belong to the Company, not the regulator. It cites Missouri v. Southwestern Bell, 262 US 276 (1923) for the proposition that regulated companies retain their management prerogatives.

The Commission rejects this argument. It is not interfering with management prerogatives in any way. The Commission did not prevent company management from doing anything. The Commission is making a ratemaking adjustment for excessive earnings that the Company earned or could have earned or retained the right to earn, based on agreement and historical precedent.

10. The Company argues that nothing in U-86-156 or U-89-3524-AT decide this issue.

i) The Company contends that the orders do not address today's policy issues: cross subsidization and harm to competition. The Commission rejects the argument. The earlier orders did not anticipate and do not address some current circumstances or policy issues. That does not render them invalid. The Commission has the power to modify earlier orders when it believes doing so is appropriate, under pertinent statutes.

ii) The Company argues that neither docket was a rate case and no finding in those cases forecloses USWC from litigating the issue of subsidizing competitive and potentially competitive telecommunications services with Directory income; the agreement is obsolete. The Commission rejects the argument. That neither prior proceeding was a rate case appears to be irrelevant. The Commission specificallly finds that the imputed revenues do not provide a subsidy to any customers or class of customers. The agreement is not shown to be obsolete.

iii) The Third Supplemental Order in U-89-3524 did not actually affect rates and thus was not ripe for appeal on this issue. The Commission rejects the argument. The Commission disagrees that the order was not ripe for appeal; whether the order actually affected rates would not determine whether it was appealable.[23]

iv) MRG gets listings on the same basis as other companies. The Commission rejects the argument. MRG's access to listings and preferential or lack of preferential status regarding access to the listings are not the basis for this decision. The Commission is not regulating MRG but is attributing revenues based on several grounds: the Company's foregoing its ability to maintain a historically integrated operation benefiting ratepayers, its failure to secure benefit for losing the regulatory asset, and its failure to secure compensation for the benefits that MRG currently enjoys. MRG's current market advantage stems from its exclusive arrangements with USWC and not from its nonexclusive ability to secure listings.

v) USWC argues that it did not waive any rights by conceding imputation until further order because an agency does not have the power to define the scope of its own authority (In re Consolidated Cases, 123 Wn.2d 530 (1994)). The Commission rejects the argument. USWC had every opportunity to litigate and every right to appeal the Commission's order in U-89-3524-AT. It did not, and it now concedes that the order provided that directory revenues will be imputed unless and until altered by subsequent order.

vi) USWC argues that the agency gets its power from the legislature, "not from extracting agreements from regulated companies on pain of denial of that to which they are entitled by law." [Emphasis added; USWC Revenue Requirements brief, p. 9] . The Commission rejects the argument. There is no evidence that the Commission or Commission Staff or anyone else extorted something in a way that was improper. On the contrary, the agreement appears to have been entirely voluntary.[24]

---

[23] RCW 34.05.530 reads as follows: Standing. A person has standing to obtain judicial review of agency action if that person is aggrieved or adversely affected by the agency action. A person is aggrieved or adversely affected within the meaning of this section only when all three of the following conditions are present:

(1) The agency action has prejudiced or is likely to prejudice that person;

(2) That person's asserted interests are among those that the agency was required to consider when it engaged in the agency action challenged; and

(3) A judgment in favor of that person would substantially eliminate or redress the prejudice to that person caused or likely to be caused by the agency action. (1988 c 288 § 506).

[24] The Commission addresses all of the Company's arguments presented as to yellow page revenue imputation, even though many of the arguments are repetitious of matters previously argued and decided, and others are so patently silly that they insult the Commission's intelligence. USWC's argument that in effect alleges extortion, however, is shocking and outrageous. USWC presented not one iota of evidence supporting this claim. The Company's

11. USWC contends that the Staff is wrong, and the Tunney Act proceedings[25] didn't set the policy that directory earnings should defray local service. The Tunney Act case was only to determine whether the consent decree was consistent with the public interest under antitrust principles. The decision only contemplated that directory revenues would offset local exchange costs, and did not authorize or require that to happen. The Tunney Act decision ruled improper a provision in the Modification of Final Judgment (MFJ) that Regional Bell Operating Company (RBOCs) be excluded from directory publication. Other than that, the decision was dictum.

The Commission rejects this argument. While the decision clearly did not specifically order imputation, there is nothing in the decision that would support USWC's position or indicate any judicial impediment to imputation. On the other hand, imputation is a logical and appropriate consequence of the decision.

12. The Company contends that Staff's suggestion that the Company be required to pay competitors the amount of the imputation is beyond the Commission's statutory power and illustrates the need to end imputation.

The Commission does not accept the Staff suggestion. It would appear to raise substantial issues that are not necessary to decide and that the Commission does not choose to address in this proceeding.

13. The Company argues that Staff and Public Counsel/TRACER are in error in assuming that the future will forever replicate the past, and that the state has the power to seize profits of non-utility affiliates.

The Commission rejects this argument. The Company mischaracterizes the Commission Staff and Public Counsel/TRACER positions and the result of the proposed action. Neither never-ending imputation nor seizure of income is contemplated or attempted here. The profits of non-utility affiliates are not touched in any way. They are merely imputed to USWC, as is permitted by law.

14. USWC contends that MRG does not have a monopoly and its return isn't inconsistent with competitive returns in the advertising business. It argues that there is no

---

record of litigation before this Commission and in the courts demonstrates clearly that it knows how to secure redress speedily and successfully if it believes that its interests are adversely affected. If extortion occurred, unbeknownst to the Commission, we call on the Company to bring forward that evidence so investigation and possible prosecution can occur. Without that evidence this accusation has no place in a professional presentation.

[25] United States v. Western Electric Co., 552 F.Supp. 131, 148 (D.D.C. 1982), Aff'd. sub nom Maryland v. United States, 460 U.S. 1001 (1983).

evidence that USWC's association with USWD leads people to advertise in the directory. The directory does not use public right of way or eminent domain power of the utility. Imputation conflicts with RCW 80.36.300, encouraging diversity of supply.

The Commission rejects this argument. MRG's possession or lack of a monopoly in the directory market does not appear critical to the imputation decision. The Commission finds that USWC's association with MRG is a benefit to the directory, based on the testimony of Staff and Public Counsel/TRACER witnesses and its mention as a benefit by more than one "public" witness. No one is contending that the directory uses public right-of-way or powers of eminent domain. No party is contending that the law of right of way or eminent domain support imputation of directory revenues. Imputation has nothing whatsoever to do with diversity of supply as it imposes no restrictions whatsoever upon diversity.

15. USWC contends that the proposal violates USWC's constitutional rights. that Staff's proposal to pay customers of other carriers is confiscatory and that treating USWC differently and more harshly than other carriers is discriminatory.

The Commission rejects USWC's arguments. Staff's proposal to fund customers of other companies is not accepted. USWC is treated fairly, based upon USWC's unique circumstances . There is no impermissible discrimination. See, Oregon P.U.C. v. Pacific Northwest Bell Telephone Co., Docket UI-54, Order 88-488 (May, 1988).

16. The Company contends that imputation contradicts the general purpose of regulation, which is to simulate the result of an unregulated market. An unregulated business would never subsidize a less profitable line with a more profitable line.

The Commission rejects this argument. The Company cites only one of the underlying principles of regulation. It is also a recognized principle that the Commission must regulate in the public interest.[26] Utilities, operating as natural monopolies, may have the power to operate for their own corporate interests, adversely to the interests of ratepayers. The Commission is charged with protecting the ratepaying public. One of the Commission's functions has been has been to protect customers of noncompetitive services from utilities' self-dealing. Utilities may have the power to subdivide the integrated utility operations and divest for their own organizational goals or profit objectives any discrete, divisible, and potentially profitable aspect of that operation. Imputation is entirely consistent with the purpose of regulation as a tool

---

[26] RCW 80.01.030 reads in part as follows: The utilities and transportation commission shall:

* * * *

(3) Regulate in the public interest, as provided by the public service laws, the rates, services, facilities, and practices of all persons engaging within this state in the business of supplying any utility service or commodity to the public for compensation, and related activities; including, but not limited to, ... telecommunications companies . . ..

to minimize adverse effects on such division and divestiture when those circumstances occur.

17. USWC argues that the Telecom Act says USWC must allow resale at wholesale rates, discounted from retail rates. This means, it says, that the imputation subsidy for consumers would flow to the resellers who compete with USWC. Imputation denies USWC equal protection.

The Commission rejects this argument. Imputation will not benefit resellers, as the critical issue for resale is the spread (the difference between USWC's retail rate and the wholesale rate at which a reseller purchases it) and not the base on which the spread is calculated. The Commission is not, in any event, "crediting" imputed sums to any class of ratepayer.

18. The Company argues that imputation here is arbitrary and capricious. It cites WUTC v. Washington Natural Gas Co., UG-920840 (4th Supp. Order), contending that there, the Commission rejected Public Counsel's suggestion to attribute merchandising revenues to regulated activities. The Company states that the Commission is arbitrarily treating USWC differently from WNG.

The Commission rejects the Company's arguments. USWC miscites this order. In the cited order, the Commission was directing WNG to provide sufficient information to assure the Commission that operations were segregated and ratepayers were not subsidizing merchandizing operations. The Company has also cited, so is aware of, the statute preventing the Commission from attributing merchandise sales revenues to regulated operations.

Having found the appropriate calculation of the adjustment, and concluding that the Commission has the power to make the adjustment, the final question is whether the adjustment should be ordered.

The Company argues that it is inappropriate to subsidize exchange rates in a currently competitive market, and that the subsidy proposed by staff and Public Counsel/TRACER will stifle any potential competition. The Company argues that USW Direct does not have a monopoly, and identifies numerous other directories published in the state of Washington. We have noted above that whether or not the directory company has a monopoly in directory marketing is not critical to the decision. We find that it certainly has advantages through the relationship between these affiliates that other directory companies do not have. We note Mr. Brosch's comment that no competitor for local exchange service has ever complained about imputation. We find that imputation is not shown to affect adversely any competition for local exchange service, although we commend USWC for being an advocate on behalf of potential competition. We reiterate that in any event we do not attribute imputed revenues to any customer class.

In making this decision, we also consider the unchallenged fact that the vast majority of USWC's 15 jurisdictions also impute directory revenues. We note USWC's concession on brief that the matter was decided in a prior order. We note (1) Mr. Brosch's testimony that US WEST Direct grossed approximately a billion dollars and earned a return of 205% in 1994, (2) his contention that for Washington operations it earned 229%, and (3) his contention that US WEST Direct's return on equity has exceeded 150% every year since 1989, when publisher fees ended. We find that the segregated US WEST Direct operation did in fact earn substantially more than the authorized utility rate of return on its investment.

We note that an integrated operation would consider those revenues from ratepayers as a part of its operating income. Divesting that operation therefore hurts ratepayers substantially, and should not be done unless protections are in place for ratepayers. Here, imputation provides that protection.

Another analysis supports imputation, as well. The divestiture of a money-producing element of integrated operations so closely related to service without a return benefit appears to have been manifestly imprudent. See, WUTC v. Puget Sound Power & Light Co., Docket Nos. UE-920433/920499/921262 (Consolidated), 19th Supp. Order (Sept., 1994). This adjustment could also be supported on the basis of a prudence analysis.

C. Service Quality

Service quality issues are addressed in Part Three of this Order.

III. Operating Expenses

The next general area for study is operating expenses, that is, an examination of the Company's reported expenses in conducting its regulated operations. Ten different areas are in dispute. These adjustments may also have a rate base component; when that is true the adjustment will carry through to rate base in the accompanying table under the same adjustment number.

A. Restructuring PFA-9

During the test period, the Company was conducting a four-year restructuring program, reducing the size of its workforce and reducing the number of customer centers from 560 to 26. It expects substantial savings from the program over time. Most of the costs relate to personnel downsizing -- costs of early retirement and severance. The Company took a one-time pre-tax write-off of $880 million in 1993 relating to restructuring costs financial statement purposes. The Company proposed, then withdrew, an adjustment for this activity.

Commission Staff and Public Counsel/TRACER propose adjustments. They point out the experienced expenses do not represent the ongoing expense level and that the substantial expenses of the program occur in its first three years, while the savings are continuing. They contend that it is improper for ratepayers to pay the expenses in rates, but not receive the benefits of lower expense levels. Commission Staff witnesses Ms. Strain and Ms Erdahl propose that the test year costs and benefits be netted and adjusted out of the test year. That would allow the Company test year benefits. Public Counsel/TRACER witness, Mr. Carver, would remove the test year costs but leave test year savings. Public Counsel/TRACER contend that the Company proposal would not present any of the ongoing savings to be derived from the restructuring costs when benefits will exceed costs in 1997 and thereafter.

The Commission rejects the Company's position that no adjustment is appropriate. The evidence demonstrates that during the test period, costs of implementing the restructuring were greater than any benefits derived. This net cost is embedded in the test year actual results. The Company's stated purposes for the restructuring is to reduce costs and increase efficiency. There is no evidence that efficiency and quality of service are increased. It is inappropriate to include the net cost of restructuring in the test period when on an ongoing basis the Company projects that there will be net savings with an internal rate of return greater than the Commission's authorized return. Commission Staff's position, which treats results as if the restructuring did not take place, is fair. Public Counsel/TRACER's position, which attempts to leave net savings in the test period, cannot be verified. Further, to the extent that savings exist in the future, they will be present in the Company's results and if we continue traditional ratemaking, should be returned to ratepayers through lower rates.

The Commission accepts Commission Staff's adjustment PFA-9 and rejects Public Counsel/TRACER adjustment relating to restructuring. This adjustment increases net operating income by $11,408,953 and decreases rate base by $11,766,524.

B. <u>OPEB Curtailment Loss, Adjustments PFA-10</u>

The Company's proposed adjustment restates the effects of restructuring on "Other Post Employment Benefits." Under Statement of Financial Accounting Standards (SFAS) No. 106 of the Financial Accounting Standards Board, a Company is required to recognize a curtailment loss or gain when the Company experiences any event which significantly alters the expected years of future service of active participants. The present value of post-employment benefits is recorded as an expense at the time they are accrued, in order to reflect the Company's long-term obligation. The obligation is valued on the basis of statistical averages of employee service before separation or retirement.

Because the restructuring program resulted in a large number of early retirements -- some 2,200 -- the average future service of Company employees dropped during the test year. As a result, the Company booked a curtailment loss in 1994. The Company proposes an adjustment to reflect the curtailment loss during the test period.

Commission Staff and Public Counsel/TRACER oppose the Company adjustment, contending that the restructure is a one-time event and that savings from restructuring will more than cover additional expense.

The Commission accepts the Commission Staff argument. It finds that the restructuring is a one-time event and that restructuring savings will offset any additional costs. It acknowledges, as the Company argues, that the Company is required to make the adjustment for financial accounting purposes. In accepting the Commission Staff adjustment for restructuring, above, we did acknowledge that savings would grow and expenses would fall, and that savings would thus exceed expenses. That excess, we reason, offsets the proposed adjustment. Therefore we reject the Company's proposed adjustment.

C. Jurisdictional Separations

Washington ratepayers are responsible only for Washington-related expenses and costs. Because the Company operates and uses its facilities in providing interstate communication, the total costs associated with the Company's operation are allocated or "separated" between Washington (intrastate) operations and the Company's interstate operations. The Company results reflect the monthly allocations during the test period.

Commission Staff noted that during the 14 months of information available on the record, intrastate allocation factors trended downward and interstate factors trended upward. Commission Staff contends that because the intrastate allocation factors are trending downward, the test period is not representative of ongoing factors. They contend that their review of Exhibit 722 clearly indicates that trend, which requires the increased allocation of costs to the interstate jurisdiction.

The Company contends that this is error, that there is no reason to support the change except a lower revenue requirement, and that use of a test period is designed to account for such variations. They also contended in a data response that rather than trending, the separations figures are merely "fluctuating."

A test year is used to compare relationships over time for an accurate picture of Company operations. However, when the test year average is inaccurate, it is appropriate to make such adjustments as needed to produce an accurate picture.

Here, Exhibit 722 clearly shows a trend rather than a fluctuation. The Commission finds that the relationship between interstate and intrastate operations has changed, and the relationship during the period that rates resulting from this proceeding may be expected to be effective is more accurately represented by use of the December figures rather than the test year monthly figures. The Commission Staff adjustment is accepted. This shows an increase to net operating income of $6,805,250 and a decrease to net rate base of $35,722,831.

D. External Relations SA-11

This adjustment is made to remove expenses related to company corporate image advertising and related External Affairs supervision. Commission Staff witness Mr. Hua proposes to remove the corporate or image advertising that was not part of Staff's affiliated interest adjustment RSA-5. He also proposes to disallow an allocated share of the supervision in the external relations department. Mr. Hua's original adjustment disallowed substantially more of the costs in the nine categories in this department. He revised his adjustment based on information that the Company eventually supplied.

Ms. Wright rebuts Mr. Hua's adjustment. She argues that public policy type work functions are a necessity in a regulated environment. Her rebuttal testimony (pages 50-52) gives a description of costs included in each of the 9 categories. She states that only one category should be removed from regulated results, and that the Company has removed those costs.

The Commission accepts the Commission Staff proposed adjustment to remove the image advertising but not the allocated supervision. There appears to be little contest as to the specifics of the advertisements in question. Corporate image advertising is not shown to benefit the ratepayers. It is appropriately disallowed in telephone rate cases.[27] The amount of the adjustment to net operating income is $338,911.

E. Promotional Advertising, SA-8

In this adjustment, Commission Staff proposes to disallow $6.3 million in product advertising, contending that the Company has failed to demonstrate that the advertisements generated more revenues than they cost.

The Company responds that this test has never been applied before. Citing an order in WUTC v. Pacific Northwest Bell Telephone Co., Cause No. U-77-87, the Company contends that the appropriate test remains whether advertising encourages the purchase of services that provide a contribution above expenses. To the extent that it does so, says the Company, it should be allowed.

The Commission finds that the advertising in question is directed toward products that will provide a contribution above expenses. Staff does not contend and has not argued that the advertisements were imprudent, unreasonable, wasteful, disproportional to revenues, or flawed in any way -- only that the Company has not demonstrated that they worked by bringing in more revenues than the ads cost.

---

[27] See, e.g., Re Illinois Bell Telephone Co., 156 PUR4th 121, 193-194 (1994).

We do not think that is the proper test. Revenues may be difficult to attribute; results may not be immediate. The decisions from other jurisdictions cited by Commission Staff do not support the principles for which they are urged, and the suggested standard is not shown to be appropriate. For these reasons, we reject the Commission Staff proposed adjustment.

F. <u>Interconnection with Independents, PFA-11; C-2</u>

This adjustment related to local exchange interconnection. The parties agreed that the adjustment would be resolved by judicial review of Commission Docket No. UT-941464, and the Company withdrew the adjustment.

G. <u>Compensation Issues</u>

1. <u>Wages and Salaries: RSA-1 and -2; PFA-1 and -2; SA-12; B-2; C-11; C-12; and C-14</u>

The Company proposed several adjustments to payroll expense to pro form the impact of wage or salary increases during or after the test period. Adjustment RSA-1 pro forms the impact of wage increases during the test year for occupational (non-management) employees. RSA-2 pro forms salary increases for management employees that were implemented during the test period. PFA-1 pro forms the impact of a wage increase for occupational employees subsequent to the test period. PFA-2 pro forms salary increases to management employees subsequent to the test period. The Company's proposed adjustments pro form both the operating expenses and the rate base for these increases.

Ms. Erdahl, Staff's witness, states that the test period wages are not representative, in that they contain excessive overtime and an abnormally low level of capitalization. Ms. Erdahl proposes adjustment SA-12 to decrease the level of overtime from that experienced during the test period and to capitalize a greater portion of the total salaries incurred during the test period, reducing test period operating expense. Ms. Erdahl 's normalized levels for overtime and capitalization are based on a two-year average for overtime and a four year average for the capitalization percentage. Ms. Erdahl revised the Company's pro forma adjustments to give effect to her overtime and capitalization adjustment.

Ms. Erdahl also proposes to exclude team and merit awards from base wages used to calculate RSA-1 and -2 and PFA-1 and -2. She argues that these payments are discretionary. She identifies previous Commission orders excluding bonuses from base wages in pro forma calculations. Finally, she proposes to exclude the rate base impact of the Company's proposed pro forma adjustments. Commission Staff argues that it is inappropriate to pro form rate base, citing prior Commission order on the topic.

Public Counsel/TRACER sponsored witness Carver. The witness objects to the Company's presentation on the basis that it is imbalanced. He contends that the Company pro forms wage rate increases when total payroll costs are declining. As a result, he proposes to reject the Company's PFA-1 and -2 adjustments. He also would reject the rate base impact of adjustments RSA-1 and -2. As does Commission Staff, he contends that the rate base adjustments pro form the effects of "costs" that will never exist. Finally, he proposes adjustments C-11 and -12, to annualize the last quarter of 1994 payroll in lieu of the Company's pro forma payroll.

The Company contends that the Commission Staff and Public Counsel/TRACER adjustments are arbitrary and capricious, and offered without evidence to support normalization.

The Commission in general accepts the Company's presentation on these adjustments. The Commission rejects Commission Staff's proposed adjustment to decrease overtime and increase the capitalization percentage. As Ms. Wright testified (Ex. 154), the use of overtime is a management tool. There appears to be no contention that the Company misused that tool. Further, there is no evidence that the increased level of capitalization, if appropriate, would correspondingly result in lower wage expense.

The Commission also rejects Public Counsel/TRACER proposed annualization adjustments. The Commission is not convinced that the end of the year employment is representative of the ongoing level of employment in this proceeding, and believes that the Company presentation reflects a satisfactory relationship.

The Commission does accept Commission Staff's proposal to remove bonuses from base wages in the calculation of pro forma wages. The bonuses are discretionary, and are not certain at any level. Further, as discussed later in this Order, the Commission rejects the Company's Team and Merit Awards.

Finally, the Commission agrees with Commission Staff and Public Counsel/TRACER that it is inappropriate to pro form rate base for the wage increase. Such pro forma rate base adjustments would increase rate base for amounts that will never be incurred. Such pro forma rate base adjustments would result in increases to the entire rate base for increases in the unit cost of the components. This type of restatement would run counter to the industry's actual historical experience of declining costs.

The Commission has recalculated the pro forma payroll adjustments based on the above discussion, as follows: Adjustment RSA-1 decreases NOI by $1,972,844; Adjustment RSA-2 decreases NOI by $747,663; Adjustment PFA-1 decreases NOI by $3,381,860; and Adjustment PFA-2 decreases NOI by $1,482,081.

2. Compensated Absence Adjustment, RSA-12

The Compensated Absence adjustment has to do with paid leave, such as sick leave. The Company books estimated figures monthly, then makes true-up adjustments to make the test year accurate. In this adjustment, the Company proposes to adjust the test year expense to the actual amount incurred during that year. Commission Staff contests the adjustment, contending that it is selective and to the ratepayers' detriment. Commission Staff argues that the monthly accrual amounts represent a more appropriate "going forward" amount. Staff adjusts test year expense to this level.

Here, the Commission accepts Ms. Wright's representation that the true-up adjustments are accurate, and accepts the test year employment level as sufficient for regulatory purposes. The Commission accepts this Company-proposed adjustment, which reduces NOI by $390,000.

3. Team and Merit Awards/TPA, RSA-13

a. Team Awards

During the test period, the Company awarded employee bonuses called Team Performance Awards based on Company performance. The total award was based on customer service measures; quality indicators; Company net income; and business units. During 1994, no payment was made for the service quality component. The Company, through Ms. Wright, proposes adjustment RSA-13 to restate this expense to the level paid for the test period.

Commission Staff proposes to disallow the team and merit awards. Ms. Erdahl's presentation makes it clear that a portion of the awards were accrued for customer service and quality indicators (Ex. 670); Commission Staff witness Beaton proposes that these amounts should be disallowed. The remaining $5.9 million allocated to Washington intrastate operations are awarded based on USWC net income and business unit results (see Ex.662, p. 25). Ms. Erdahl states that these awards, based on USWC results, do not benefit the Washington ratepayer.

Commission Staff argues that the Company has not demonstrated that the events that raise net income benefit the ratepayers. Commission Staff states that net income and customer service are often at cross-purposes with each other, and point to their contention that service quality is deteriorating.

The Company contends that the disallowance should be rejected because it is contrary to the evidence; contrary to well-established precedent; and contrary to sound compensation practices. USWC witness Paul Gobat contended that the Team and Merit awards are an integral and significant portion of management wages for USWC. He states that USWC compensation is reasonable -- in fact, lower than the market average. He states that awards based on net income are beneficial to ratepayers, and that 50% of the scheduled awards were based on quality indicators and customer service. Ms. Wright also addresses this issue and presents a sample of how the team awards are granted. She states that goals related to net income are beneficial to ratepayers because the increase in net income is created by employees working to reduce costs, and reduced costs result in reduced need to increase rates.

The Commission finds that the team and merit awards have not been shown to benefit the ratepayer, and accepts the Staff-proposed adjustment. As the Company notes, award programs have been accepted as proper expenses for ratemaking purposes by this and other public utility commissions. This Commission has observed that management should have the flexibility to reward good performance and productivity increases[28] and has accepted a program that it observed was not perfect.[29] In the latter proceeding, however, the Commission gave a clear message as to its view of the purpose and structure of an allowable plan:[30]

> The Commission does agree with Staff that some of the (Washington Natural Gas Company) incentives fall short in terms of sending employees the message that the purpose of the program is to encourage improved service. The Commission believes, however, that the Company can do a far better job in the future of creating incentives and setting goals that advantage ratepayers as well as shareholders. Such goals might include controlling costs, promoting energy efficiency, providing good customer service, and promoting safety. <u>Plans which do not tie payments to goals that clearly and directly benefit ratepayers will face disallowance in future proceedings.</u> (Emphasis added.)

In the USWC plan, only a portion of the incentives were directly tied to service or service-related elements. The service goals were not met and that portion was not distributed. The income-related portion, however, was met and exceeded. What is particularly objectionable about this plan is not only that the financial incentives were independent of the service incentives, but the program was constructed so that, if the Company exceeded the stated financial goals by only 8%, employees could "replace" all of the bonus that they would "lose" for failure to achieve customer service goals (Ex. 189, fourth and twelfth pages).

As the Commission noted in the Washington Natural Gas order cited above, there is a potential tension between service quality and earnings. A firm can concentrate on financial elements so heavily that it can lose sight of the importance of providing customer service. In a

---

28 WUTC v. Pacific Power & Light Co., Cause No. U-86-02 (1986).

29 WUTC v. Washington Natural Gas Co., Docket No. UG-920840, 4th Supp. Order (1993)

30 Id., page 19.

public utility service, where many customers have no reasonably substitutable alternatives, the Commission must substitute for the competitive market in assuring that customer service remains a priority to the business. Financial goals are at best a very crude way to measure specific efficiencies that employees can accomplish.

The Commission finds that the Company's team award plan is not acceptable because, with a structure allowing financial rewards to eclipse customer service failures, it sends the message to employees that service quality is much less important than financial performance. This provides motivation to choose cost saving measures that unduly compromise service quality. The Company plan fails to tie payments to goals that clearly and directly benefit ratepayers. The Company's service quality clearly failed to meet acceptable standards during the test period, as discussed above, while the Company exceeded its financial goals. Whether or not the structure of team awards contributed to this circumstance, it is certainly consistent with the circumstance.

Problems with the plan could be corrected in many ways, including the payment of financial performance awards only after service quality goals are met; tying the amount of awards for other indices to service quality performance; or tying financial-based awards not to the bottom line but to objective employee performance that promotes both efficiencies and customer service. For this proceeding, the Commission accepts the Commission Staff adjustment.

b. "Merit" Awards

Commission Staff's proposed adjustment also would disallow merit awards granted to individual employees.

Merit awards to individual employees, which are clearly based on the evaluation of employee performance upon appropriate standards, should not ordinarily be second-guessed or micromanaged by a regulator. The use of merit awards and the fairness of their distribution are matters for the Company to decide and for which it will ordinarily reap the positive and the negative consequences. Here, however, Commission Staff calls into question the standards by which the awards are granted.

The Company presented little evidence about those standards, and there may be inconsistencies within that evidence. Commission Staff notes that Ex. 221 defines merit awards using the same criteria as are used to define the team awards in Ex. 189. Ex. 190 does not distinguish between criteria for the two. Ex. 189 states at page 2 that a portion of the team performance award constitutes "discretionary payouts for individual employees" and the segment entitled "salary adjustments" at page 4 of the attachment to Ex. 189 is the fourth page of a Team Performance Award brochure for employees. The information we have of record, therefore, indicates that the criteria for merit awards are the same as the criteria for the team awards -- or that "merit" awards are a portion of the Team Performance Awards and thus entirely dependent upon the criteria we have identified as faulty. Because we have disallowed team awards for the use of improper standards, we accept the Commission Staff adjustment and disallow merit awards on the same basis.

The effect of the team and merit awards adjustment is to increase NOI by $6,384,966.

4. Benefit Expense, RSA-14

This Company-proposed adjustment restates test year expense levels for true-ups made in November and December, 1994. Commission Staff opposes the adjustment, contending that test year capitalization is not representative. Staff also objects to the Company's restatement of rate base in this adjustment because, Staff contends, it is inappropriate to pro form rate base. Because we have accepted the Company's capitalization adjustment, and because the two are related and rise or fall on the same analysis, we accept the Company's adjustment here. We also accept the rate base portion of the adjustment, noting that the adjustment is restating and not pro forma.

5. Other Post Employment Benefits (OPEB), RMA-8

This Company-proposed adjustment restates test year OPEB expenses to reflect this Commission's prior adoption of accrual accounting during 1988 and 1989. The Company's expense level is based on the amortization of the transition benefit obligation over 17.3 years based upon the recommendation of the Company's actuary. Mr. Twitchell for Commission Staff proposes to extend the term of the amortization to 20 years. He contends that the 20-year period is consistent with SFAS 106. Staff also suggests that because of the early retirements during restructuring, the working lives of remaining employees will be longer, and calendar 1994 figures are more representative of post-period employment.

The Commission accepts the Company proposal. Although the Commission Staff concerns may have merit, the Company has presented sufficient evidence of record to support its adjustment and the Commission Staff proposal lacks sufficient specific evidence to support it. The adjustment increases NOI by $97,331 and decreases rage base by $7,036,298.

H. Regulatory Fee RSA-17-9; SA-9

The Commission Staff proposes Adjustment SA-9 to pro form the Company's regulatory fee to the rate case level and the current regulatory fee rate. The Company challenges the Staff proposal, contending that Commission Staff proposes selective true-ups and that the monthly accruals were reasonable when booked. On rebuttal, the Company does propose a small adjustment to correct test year posting errors.

The Commission accepts the Commission Staff proposed pro forma adjustment.

It reflects the proper treatment for rate case calculation, as it will best reflect the relationship between revenues and expenses going forward, and thus constitutes a better basis on which to set rates. The effect of this adjustment is an increase in NOI of $178,182.

I. Amortization of Debt Call Premiums, PFA-8

The parties agree, and the Commission finds, that the cost of call premiums paid when the Company retired high-interest funded debt is a proper expense for ratemaking purposes. The Company agrees that this expense may be recovered either through the Company adjustment or, as the Commission Staff suggests, through the use of long term debt rate reflecting the expense.

The Commission finds it more appropriate to include the amortization of these expenses in calculating the cost of long term debt. The Commission therefore accepts the Commission Staff adjustment and will recalculate the long term debt cost rate consistent with the Commission Staff suggestion to include this expense.

J. Capital Recovery, PFA-6, B-3, C-15

This adjustment relates to depreciation rates. The Company has tried to relitigate recently-decided and litigate soon-to-be decided depreciation matters in this proceeding, and the Commission has declined to do so. The Company challenges that refusal, contending that it illegally harms the Company.

The Commission acknowledges that the use of accurate depreciation rates is an important element of ratesetting. The Commission reiterates its prior rulings, however, that it need not relitigate the recently-decided depreciation methodology and rates that the Company sought to support in this proceeding with virtually the same evidence -- word for word -- that the Commission considered in the just-completed interconnection proceeding.

The Commission has also noted that the triennial represcription of lives, involving the Commission, the FCC, and the Company, is underway. It is a consideration of some depreciation elements. Upon conclusion of the represcription process, the Commission will consider adjusting rates if doing so is procedurally appropriate and consistent with regulatory principles.

The Commission sees no reason now to reverse its prior rulings on this matter.

We do note that Commission Staff has prepared a pro forma adjustment to implement the depreciation rates found appropriate in Docket No. UT-940641. The Company does not contend that Mr. Spinks' calculation is in error. The Commission will adopt Commission Staff's pro forma adjustment to depreciation expense and accumulated depreciation. The effect of the adjustment is an increase in NOI of $5,049,375 and an increase in rate base of

$1,165,240.

IV. Affiliated Transactions

A. General Considerations.

The Company purchases a number of services from companies that are affiliates. Affiliated interest transactions have long been subject to particular scrutiny in utility regulation, both in this state and in other jurisdictions. A company might be tempted to divert functions to unregulated affiliates so that stockholders might earn a higher unregulated return from the affiliate than they might from a regulated entity, with ratepayers consequently responsible for higher expenses than might be experienced in an integrated regulated company. Courts also point to the lack of an arms-length relationship between contracting affiliates, and the resulting temptation to avoid hard bargaining that might be available in a competitive environment.

In Washington State, the Commission has consistently used RCW 80.16.030[31] to protect ratepayers from possible harm from affiliated transactions. The regulated company bears the burden of demonstrating that the payment is a reasonable amount; if it does not do so, or if it does not show the cost to the affiliate of rendering service, the Commission is instructed to disallow payment.[32] The standard for a reasonable price is the lower of the competitive market price or the affiliate's costs plus a fair return.[33]

---

[31] The statute reads as follows (emphasis added):
80.16.030 Payments to affiliated interest disallowed if not reasonable. In any proceeding, whether upon the commission's own motion or upon complaint, involving the rates or practices of any public service company, the commission may exclude from the accounts of such public service company any payment or compensation to an affiliated interest for any services rendered or property or service furnished, as above described, under existing contracts or arrangements with such affiliated interest unless such public service company shall establish the reasonableness of such payment or compensation. In such proceeding the commission shall disallow such payment or compensation, in whole or in part, in the absence of satisfactory proof that it is reasonable in amount. In such proceeding any payment or compensation may be disapproved or disallowed by the commission, in whole or in part, unless satisfactory proof is submitted to the commission of the cost to the affiliated interest of rendering the service or furnishing the property or service above described.

[32] RCW 80.16.030.

[33] WUTC v. Washington Natural Gas Co., Docket No. UG-911236, Third Supp. Order (Sept., 1992).

This record presents evidence regarding affiliated transactions with Marketing Resource Group (MRG), to which the Company sells billing and collection services, publisher products, and directory placement at public pay stations; Business Resources, Inc. (BRI), from which the Company purchases procurement, warehousing, and delivery services; with Bellcore and US WEST Advanced Technologies (USWAT), from which it purchases research and development; and with US WEST, Inc. (USWI), from which it purchases various management services.

B. Marketing Resource Group, SA-4 and C-4

The Company receives revenues from an agreement with MRG for services that it provides: billing and collection, publisher products, and directory placement at pay phones. It records some of the revenues that it receives for this service -- cost, including a return -- as operating income. However, when revenues exceed costs, it records the excess revenues below the line, not considering them as income for purposes of regulation.

Commission Staff and Public Counsel/TRACER would make adjustments to consider the below the line revenues for ratemaking purposes. The Company challenges the adjustments and defends its approach, contending that it is merely following accounting practices established by the Federal Communications Commission (FCC) that the Commission has adopted.

Commission Staff and Public Counsel/TRACER contend that the requirement to use FCC accounting for book purposes does not govern accounting analysis for rate of return regulatory practices, noting that the FCC rules do not constrain USWI from incurring costs for image advertising, lobbying, and charitable contributions. Public Counsel witness, Mr. Brosch, noted that the services are part of MRG's costs and are deducted from the imputation, so should be reflected as income to USWC. (Ex. 390-T, p. 111)

The Commission finds no facts, no rationale, and no citations of authority, to indicate that the Company's accounting practice is appropriate for ratemaking purposes. Accounting for book purposes, even pursuant to rules that the Commission has established or adopted by reference, does not control accounting for ratemaking purposes. WAC 480-120-031(1)[34] All the revenues from MRG for those functions should be considered above the line revenues for ratemaking purposes. The revenues relate to a formerly proprietary function, a regulatory asset, that the Company transferred without compensation. Under the Company's proposed treatment, the ratepayers would not only be deprived of the revenues from earnings, but also deprived of the full benefit of payment for services it formerly performed for itself, thus losing twice. The Commission accepts Commission Staff's calculation of the adjustment,

---

[34] WAC 480-120-031 reads in part as follows:
The accounting rules for book and recording purposes do not dictate intrastate ratemaking.

virtually identical to that of Public counsel/Tracer, increasing NOI by $1,052,896.

C. Business Resources, Inc. (BRI), SA-7

USWC purchases procurement, warehousing, and delivery services from BRI. Commission Staff contends that alternative services are available from other vendors at a much lower cost than USWC paid to BRI. It calculated the affiliate's costs plus a fair return, and it considered the price of alternative resources based upon Company studies. In proposing its adjustment SA-7, it used estimates of market price based upon a 1988 Company study. It proposes an adjustment of $2,374,375 to net operating income based upon its analysis.

USWC challenges the adjustment, contending that the underlying information that Staff uses is out of date and, in any event, that it is entitled to consider non-cost factors such as the affiliate's track record and its understanding of Company procedures. It notes that the Commission as a State agency is entitled to consider non-cost factors in its procurement.

The analogy with Washington State procurement requirements is not well-taken. The issue is not whether the Company is entitled to enter a contract with an entity other than the lowest bidder. The Commission acknowledges that the Company can lawfully enter a contract for services with virtually whomever it chooses -- in most circumstances with limited Commission review. That is a management prerogative with which the Commission is loath to interfere. The question here is not entry of a contract, but allowance of expenses for ratemaking purposes. The contention that BRI is better because of its history with the Company is entitled to little weight because any contractor might be expected to develop a track record and understanding of Company procedures if given the opportunity. The Company provides no objective evidence demonstrating BRI's superiority or justifying the additional expense. Nor, as the Company appears to allege, is the issue whether BRI overcharged USWC.

Instead, the issue is the financial consequences of such a contract and whether payments under the contract are reasonable by the objective standard stated above.[35] Here, we find that the Company has not demonstrated that the payment is reasonable under pertinent standards.

The Company challenges use of the 1988 study as outdated, contending that it fails to provide an accurate picture of market prices and that its 1990 study is better. Commission Staff responds, and we find, that the 1990 study is flawed and appears to contain double loadings. Therefore, it should be excluded.

The Commission accepts the Commission Staff use of the competitive bids for

---

[35] Commission Staff does not allege that the contract payments are imprudent.

purposes of pricing the affiliated interest transaction.[36] The Commission finds the testimony of Ms. Strain credible in support of this adjustment.

In conclusion, because the transaction is with an affiliate, the Commission may look to the lower of the affiliate's costs or the market price for comparable services to establish the reasonableness of the charges. Here, the credible information as to market prices is the 1988 study and Ms. Strain's testimony. USWC contends that it is entitled to recognition of higher payments, because it believes BRI provides better service than a low bidder might, but it provides little evidence beyond conclusory statements that BRI knows a great deal about USWC's business. The burden of proof to justify affiliated interest transactions is higher than such bare allegations.

D. Research and Development, SA-7, C-6, C-7, and RSA-10

No party challenges the generic propriety of research and development expenses for the Company's operations. It must continually look to the future and to its need to maintain its position as a leader in technology, both as an element of its service to present customers and as an element of its preparation for a fully competitive environment.

The issue instead is whether and to what extent ratepayers should fund the activities. Courts have acknowledged the appropriateness of disallowing projects that are unlikely to provide ratepayer benefit[37] or have required a strong showing of benefit to ratepayers in the near future and have categorically disallowed "fundamental research."[38] The parties look to specific elements of the transactions with the two R & D suppliers, Bellcore and USWAT to determine whether the item should be allowed or disallowed.

Commission Staff notes that the Company allocated costs between regulated and unregulated activities by the size of the entities and not the purpose or benefit of the project. Commission Staff reviewed the payments, and proposes to disallow many of the expenses and to expense others over their useful life. Staff proposes to disallow 50% of the costs of a number of research projects which, it argues, have deliverable commonalities. Staff criteria for decision included whether an individual project had benefit to Company operations that are now deregulated or that provide no perceived benefit to current ratepayers for regulated tariff service. (Ex. 631-T, p. 17).

---

[36] Use of comparable prices requires considerable judgment. Comparable prices are based on estimates that the Company gains from businesses who may look at the relationship between USWC and BRI, as well as the history of the contractual relationship, and perceive that they have no realistic chance of securing USWC 's business.

[37] See, Re USWC, 142 PUR 4th 1, 29-31 (Utah P.S.C., 1993.

[38] See, Re AT&T Communications, 107 PUR4th 381 (La. P.S.C., 1989).

Public Counsel/TRACER witness, Mr. Brosch, discusses the costs associated with research and development by USWC affiliates U S WEST Advanced Technologies (USWAT) and Bell Communications Research, Inc. (Bellcore) on page 63 of his testimony. The projects he removed dealt with multimedia services, future video, and broadband and wireless network technologies. As does Commission Staff, he finds that many of the projects undertaken by these affiliates do not have current ratepayer benefits. Many of the projects either extend to nonregulated activities or relate to services far beyond the potential of current telephone technology. His disallowance proposals suggest that if at some future time the Company can demonstrate that these projects do benefit ratepayers, they should be allowed to request recovery of the costs with interest. A side record would be kept to track potential future recovery. As documentation he provides Exhibits 394, 395 and 396 to show descriptions of the contested projects. On rebuttal, he states that his adjustments on Bellcore, USWAT, and the parent vary from staff's mainly on the basis of scope. He believes his position to be more conservative than that of Commission Staff.

Public Counsel/TRACER argue that research and development costs should be recovered only if reasonable. They identify four issues that must be resolved to determine reasonableness: Is there a mismatch of cost and benefit? Do unregulated operations benefit? Is there subsidization of business risk? and, Is the research unsuccessful? Public Counsel refer to a Utah order, which required deferral of certain portions of these costs.

US WEST cites WUTC v. Puget Sound Power & Light Co., 74 PUR 4th 536, 576, 577 (1986) for the proposition that there is necessarily a lag of time, perhaps years, between the investment in research and development and the realization of benefits, and that the Commission considers research and development investment to be socially beneficial, valuable to ratepayers, and pertinent to the Company's needs. USWC contends that it is similarly situated. The Commission disagrees. Differences include the relationship between the contracting parties -- in the Puget case the research was provided by a non-affiliated entity, EPRI (Electric Power Research Institute). Factors also include the nature of the industries; at the time of the order, electric companies were fully regulated and there was no hint that elements would be deregulated. Here, many aspects of telecommunications are deregulated, others are subject to substantial deregulation, and the future appears to hold the promise of additional deregulation. The Commission finds, as pointed out by both Commission Staff and Public Counsel/TRACER witnesses, that it is a very real concern that telephone company ratepayers of regulated services could be charged for research benefiting only the Company or users of deregulated services. While the Commission still subscribes to the basic principles in the Puget order, and will allow costs for projects that appear to have value for ratepayers, the language in Puget cannot be uncritically applied to justify any expense, however unrelated to regulated operations.

The Company contends that it is impossible to determine now what activities might be deregulated in the future by the legislature; that all but a few are now regulated; and that all of the research will be beneficial to ratepayers. It contends that the deferral suggested by Public Counsel/TRACER is unauthorized by law and that future recovery is illusory because single issue ratemaking and retroactive ratemaking are not permitted.

The Commission accepts the Public Counsel/TRACER approach to both Bellcore and USWAT. We prefer it to Commission Staff's similar approach because it is more clearly documented and offers long-term opportunity for recovery. We find no legal bar to using a side record for potential recovery. We find that it is specific as to project, so that benefit will be simple to determine. The approach will allow the Company to recover the costs of many projects immediately and will allow the full recovery of all deferred projects that prove beneficial to regulated operations -- in a manner that is not retroactive ratemaking, but that allows recovery on a prospective basis when benefit is determined. USWC does not demonstrate that the approach is improper, and side records may, as here, be entirely appropriate for ratemaking purposes.

Accepting the Public Counsel/TRACER adjustment C-6 increases net income by $606,000. Public Counsel/Tracer adjustment C-8 increases NOI by $286,000. Finally, as part of Public Counsel/TRACER presentation, we adopt the company proposed adjustment RSA-10, which increases NOI by $711,913.

E. US WEST, Inc., Adjustments RSA-5A, RSA-5B, and C-8

US WEST, Inc. (USWI) is USWC 's parent and an affiliate of USWC. USWI provides substantial management services to USWC and USWI's other subsidiaries. As listed in Mr. Brosch's testimony, Ex. 390-T, page 39, the services include shareholder services; executive management; treasury; legal; strategic marketing; strategic planning; corporate finance; and accounting.

USWI charges USWC for the services that it provides. USWC has recorded these charges as operating expenses, and in adjustment RSA-5 it proposes to true up expenses occurring within the test year but recorded afterwards.

Commission Staff contends that some of the amounts that USWC pays to USWI are improper for ratemaking purposes. Ms. Erdahl does not object to the Company's adjustment, but modifies it to eliminate charges for certain functions provided by USWI: executive management, human resources, public relations, and strategic planning. She contends that the USWI executive management and human resources services overlap functions performed by USWC management (Ex. 272 and 273) that are needed only because USWI is running many corporate entities. It contends that USWI's focus is on the integration of USWC with the USWI "family" and that if USWC were a company standing alone, those functions would not be necessary. The Company has its own executive management and public relations departments, Staff argues, and if USWC were an independent company the USWI functions would be unnecessary. Functions performed by USWI are largely related to unregulated operations, competitive services, support of the parent corporation itself, or are simply not needed because USWC has its own staff able to perform the functions. In addition, Commission Staff has also proposed disallowance of strategic planning involving all USWI subsidiaries and focusing on the future of USWI policy positions nationally and internationally, largely in non-regulated areas, and costs related to corporate image advertising and public relations because the Company has not provided sufficient information to demonstrate that any amount of corporate image advertising benefits ratepayers.

On behalf of Public Counsel/TRACER, Mr. Brosch proposes adjustment C-8 to disallow executive management and image advertising costs. He also notes redundancies but not exact duplication of functions between the two affiliates. Instead, Public Counsel/TRACER contend that the holding company imposes some costs that would not be necessary if there were no holding company and that USWC hasn't demonstrated that some of the USWI costs are appropriate for intrastate regulated operations. Mr. Brosch provides a list of services provided by USWI to USWC and states that costs of the new, fast-growing, non-regulated business should not be included in rates for regulated services. He discusses the Regulatory Impact Review (RIR) that was performed in connection with the 14-State Regional Oversight Committee (composed of state commissioners and staff in USWC's service territory), indicating that the review was not intended to take the place of regulatory oversight and did not make recommendations. Public Counsel/TRACER also argue that allocations based on relative affiliate size shifts costs inappropriately to regulated operations because much of the USWI focus is on non-regulated activities. Public Counsel/TRACER contend that the institutional or image advertising fails to provide a direct and primary benefit to the regulated subsidiary.

USWC argues that the Commission Staff and Public Counsel/TRACER adjustments are inappropriate. It contends that the Commission Staff and Public Counsel/TRACER positions are based on duplication of functions, and urges that there is no duplication. USWC also contends that the image advertising does promote the growth of the business and therefore should be allowable.

The Company arguments do not directly address the Commission Staff and Public Counsel/TRACER positions. Based on the evidence, the Commission finds that the USWI functions are not entirely duplicative of USWC functions, but that there is substantial overlap and that the challenged USWI functions are directed principally toward "family-wide"' matters rather than USWC issues. USWC has not demonstrated that the overlapping services are reasonable charges to the regulated subsidiary or that they are charged in proportion to the benefits received by the regulated subsidiary. If USWC were a nonaffiliated company, it does appear from the credible testimony of record that those functions could be performed by USWC existing staff or would be unnecessary.

Neither is the Commission persuaded that the costs of image advertising is appropriately borne by ratepayers. The Company contended as to a prior issue, and the Commission agreed, that the appropriate test remains whether advertising encourages the purchase of services that provide a contribution above expenses. Here, there is no evidence that the corporate image expenses meet that test. The Commission believes that the Commission

Staff proposed adjustment more accurately removes inappropriate costs, and the Commission accepts the Commission Staff proposed adjustment, which increases NOI by $1,232,375.

V. Taxes

A. Recalculation of Sharing Adjustment, RMA-9, B-4

The Company operated under an alternate form of regulation or AFOR for several years. One element of the AFOR was the sharing of excess earnings. Under that program, the Company and ratepayers shared the benefit of excess earnings according to a prearranged formula. The process was called Sharing and the ratepayer interest was called Sharing Dollars. The Commission designated the distribution of the ratepayer share, and during 1990, 1991, and 1993 used a portion as a credit to depreciation. Under the AFOR settlement, the Company was required to credit accumulated depreciation for an equal portion of the Company's share of excess earnings.

Company witness Ms. Wright proposes adjustment RMA-9, Sharing Adjustment, to give effect to the disposition of sharing dollars through the depreciation reserve for the sharing orders for 1991 and 1992. Her proposed adjustment includes an offset to accumulated depreciation for accumulated deferred taxes. The Company adjustment does not include sharing dollars allocated to accumulated depreciation for 1993.

Commission Staff witness, Mr. Twitchell, discusses the sharing adjustment. His adjustment modifies the Company's adjustment in two respects. First, he includes the 1993 sharing order, which had not been resolved at the time of the Company's filing. The Commission finds this a proper fro forma adjustment to give effect to the 1993 distribution of sharing dollars. The Company did not accept this adjustment but included only 1991 and 1992 sharing results in its presentation and did not address the issue in its brief. Including the 1993 sharing distribution is an appropriate pro forma adjustment and the Commission accepts it.

Second, Mr. Twitchell did not give effect to deferred taxes as the Company proposed. Commission Staff argues that the proposed adjustment to accumulated deferred taxes is not in accordance with previous Commission orders. Staff points out that nothing in the AFOR agreement, or in any of the Commission orders dispersing excess profits, indicates any intent by either the Commission or the Company to offset the adjustments to accumulated depreciation with an adjustment to the accumulated deferred tax balance.

Public Counsel/TRACER witness Carver proposes Adjustment B-4 to accomplish the same functions as the Commission Staff proposal. Public Counsel/TRACER agree that one of the adjustments is needed in order to preserve the ratepayer benefits of the Sharing proceedings. They point out that no Commission order "directed" a deferred tax adjustment associated with the Sharing proceedings, and argue that therefore there is no violation of the Tax Code. They urge, if the Commission rejects the proposed adjustments, that it establish a regulatory liability account not requiring normalization, or that it revisit the Sharing proceedings and consider direct refunds in lieu of depreciation credits.

The Company contends that the sharing orders and the AFOR settlement simply do not address tax consequences, and contends that it must be included now because failure to do so would violate federal law and because ratepayers are not harmed by the partial offset of deferred taxes.

The Commission agrees with Staff that it is appropriate to pro form the effect of the 1993 Sharing dollars into the calculation. However, the Commission must conclude that there should be a tax effect given to these adjustments. The Commission is, however, concerned that the Company's presentation in previous proceedings does not disclose the full nature of these adjustments to accumulated depreciation.

In fact, in two documents of which official notice is taken, a Commission Staff report and a USWC response that led to the 1991 Sharing Order, the following exchange occurred. In Commission Staff's Additional Comments in Response to the Commission's June 6 letter to parties, at page 5, the Commission Staff set out an amortization chart showing the amortization of the depreciation sharing dollars. The chart does not reflect a deferred tax offset. If a deferred tax offset were made, the figures on the chart would be incorrect.

In USWC 's response to the Commission Staff comment, the Company at page 6 acknowledges that the Commission Staff proposal would limit the Company to an 11% rate of return. However, as proposed by Commission Staff, the Company's return may well have been held below 11%. The sharing dollars represent the excess revenues, not the excess net operating income. As such, flow-through just to the depreciation expense without a tax offset would have reduced the Company's earnings below the 11%

Consequently, it appears that it is appropriate to offset the accumulated depreciation with deferred taxes. The Commission recalculates this adjustment based on Ex. 164. The effect of the adjustment is a decrease in rate base of $31,035,616.

B. Sale of Rural Exchanges, PFA-7; SA-6

In Docket No. UT-940701, the Commission accepted a settlement agreement involving the sale of 28 rural exchange properties formerly operated by USWC in Washington State. One element of the settlement was USWC 's pledge to credit depreciation reserve with $16.6 million.

USWC proposes a pro forma adjustment, PFA-7, to give effect to both the removal of the now-sold exchanges and to recognize the disposition of the gain as agreed to in the settlement agreement. One part of adjustment PFA-7 would pro form an offsetting amount for accumulated deferred taxes to the accumulated depreciation credit of $16.6 million. This is similar to USWC's proposal regarding the Sharing Dollar depreciation adjustment. USWC contends that the Internal Revenue Code requires the taxes to be recorded in this manner for ratemaking purposes.

Commission Staff opposes the adjustment. It contends, through Mr. Zawislak, that the settlement agreement does not mention and does not contemplate this offset. Commission Staff argues that the Company's proposal would deprive ratepayers of the benefit of the bargain that the Commission approved. Public Counsel/TRACER urge that the Commission adopt the same approach to this adjustment that it adopts to the Sharing adjustment, next above.

The Commission finds that the circumstances presented here differ from those of the Sharing order. Here, although we have an order that contemplates no offset, we have no pleadings that indicate parties' intent. We have no subsequent orders, and the remedy, effecting the proper tax treatment, is more easily accomplished.

The Company suggests that the credit to the depreciation reserve is the result of a charge to depreciation expense. Thus, per tax regulations, it is necessary to credit deferred taxes and as a result decrease accumulated depreciation and accumulated deferred taxes. However, the Company adjustment does not show an amount for deferred tax expense. The lack of entries associated with depreciation expense is explainable in that the credit to the reserve was by agreement in the settlement, and as with the gain on the sale of the exchanges, is not part of the pro forma adjustment. This is not to say, however, that the depreciation is not related to operations. The same is not true for the deferred taxes. The stipulation made no mention of credits to deferred taxes. The Company's failure to pro form the deferred tax credit is inconsistent with its position that the deferred taxes must be recognized for this depreciation entry.

While the Commission is not certain whether Commission Staff's position would violate the tax code, the Commission will accept the Company's contention in this proceeding. The Commission however, will complete the adjustment and include the credit to deferred tax expense.

The Commission is concerned that the Company negotiated the settlement on the gain on the sale of rural exchanges without revealing the full expected tax consequences of its position, failing to disclose or to make adjustments when timely, then taking no responsibility for consequences when tax implications of the agreement became clear. The Company has an affirmative obligation to disclose such matters to regulators.

The effect of this adjustment is to increase net operating income by $4,210,071 and decrease rate base by $43,542,000.

C. Pension Asset RSA-16

In prior years, the Company over-accrued sums for future pensions, resulting in a pension asset. The Commission Order in Docket Nos. UT-930074/930307/931378 ordered that the Company prospectively flow through the tax consequences of the pension asset. The Company as part of adjustment RSA-16 proposes to remove the previously-deferred taxes from the rate base. USWC contends that the previously deferred amounts were flowed through in the sharing proceedings in 1993 and 1994, and that Commission Staff accepted the entries.

Commission Staff contends that this is an adjustment without substance, arguing that there were no sharing dollars available in 1994. The Company, urges Commission Staff, affords no benefit to ratepayers in this adjustment. Commission Staff proposes instead to pass the benefit of the taxes back to ratepayers over three years, merely making them whole, and preventing the inequity of allowing the Company to benefit from its own booking errors.

The Commission finds that the situation before us results from a Company error, namely, the Company's previous deferral of amounts that should have been flowed through. The Commission finds that it is appropriate to correct it, as suggested by Commission Staff.

Further, the commission order in dockets UT-930074, et al., stated that, "The commission will continue to offset rate base by the unamortized deferred taxes associated with the pension asset.... In either case, ratepayers are given full credit for the deferred tax expense recognized in rates, which has not been paid or obligated to the federal government."

The Commission will adopt in principle Mr. Twitchell's adjustment regarding the deferred taxes associated with the pension asset. That treatment is consistent with the referenced order and with WAC 480-120-031, which requires flow through of these tax benefits. The Commission is aware that the Company did flow through the tax benefits associated with the year 1993 in the sharing proceeding. Therefore, the Commission will only amortize the deferred taxes accumulated through 1992, i.e., $19.4 million on an intrastate basis as determined from Exhibit 323. As a result the Commission rejects the Company's proposed rate base adjustment to remove the entire deferred tax of $22.1 million, and instead revises it to $9,137,758. This amount represents the removal of one year's amortization and the net amounts accrued on the books in 1993 and 1994.

Review of this issue leads the Commission to greater concern about the filings in the Sharing proceedings. The fourth page of Exhibit 323 is a listing of the uncontested adjustments in the 1993 sharing proceeding. On line 16, the adjustment RA-19 Pension Asset Tax Effect shows an increase to rate base of $22.2 million. If this $22.2 million is the deferred taxes of the pension asset, then this adjustment is in direct violation of the excerpt quoted above, which required the deferred taxes to be treated as an offset to rate base.

D. System X Deferred Tax Difference, RSA-16

The Company's separated results of operation contain a current item designated System X deferred Tax difference. Mr. Twitchell, a Commission Staff witness, proposes to remove the item. He states that he asked the Company for an explanation of this item, and that the Company was unable to explain sufficiently what these taxes were. Thus, Mr. Twitchell proposes to remove this item.

Commission Staff argues that this item is included in the Company's tax calculation for regulated operations simply as a plug to balance the separated income tax expense with the total Company level. The Company provides no reconciliation of total regulated taxes to regulated net operating income. Without such a demonstration, Staff recommends that the amount not be allowed.

Ms. Wright on rebuttal blames Mr. Twitchell for the disagreement, contending that his failure to understand this accounting entry should be no reason to disallow this expense. She states that the item is a balancing line. She says that taxes are calculated on a total basis, monthly, and that the balancing line is needed for system X because there is a timing difference between the unregulated calculation and the total calculation. The system X is therefore simply a self-correcting entry made to balance the total income tax expense. She further explains that the large $6 million amount was for the most part a result of the November 1993 balancing, which reflected a September 1993 depreciation represcription.

The Company argues that the Staff admits that it does not know whether this adjustment is appropriate. They argue that taxes are calculated in total for USWC and then allocated to the various regulatory identifications, including unregulated. They note that the detail from each of the units is not synchronous. They point out that the line item is simply a balancing line used in the allocation due to the asynchronous detail, and that it is ultimately self-correcting. The major portion of the system X item was recorded in November 1993 associated with a September 1993 entry associated with depreciation represcription.

Commission Staff, through Mr. Twitchell, asked for details of the calculation that would enable him to check it. He did not receive the requested information -- except the explanation that it was a figure inserted to make calculations balance.

On brief, the Company runs through its calculation and states that because the four regulatory separations processes governing the calculation are not synchronized, it is necessary to insert a filler that the Company calls a "reconciling adjustment." The Company supports the number with the contention that it is reasonable because the taxes removed are proportional to total company taxes as deregulated products are to company total income. The Company on brief again accuses the Commission Staff of "lack of understanding". The Company contends that lack of understanding is not substantial evidence that would support the Commission Staff position.

The Commission finds that the Company's explanation is insufficient to allow independent calculation of its adjustment. It finds that the Company inserted the number to make the results balance. It finds that proportionality of the tax is not sufficient to verify the number, as taxes are not shown to be a constant proportion to revenues. The Company provides no evidence that the tax calculation for the regulated operations, absent this balancing amount, is incorrect.

Further, Exhibit 158 refers to an unusually large entry in September 1993 that, when coupled with the asynchronous tax calculations between regulatory units, caused a large entry in November 1993. September 1993 is outside the test period, and test year entries to true up such amounts are not properly representative of test year expenses.

The Commission concludes that the Company has not met its burden of supporting this adjustment, and that it should be disallowed. This is a part of Adjustment RSA-16.

E. Federal Income Tax True-Ups, RSA-7 and RSA-17/OOP-4

The Company proposes these two adjustments to adjust the test year expense for out of period entries. RSA-7 adjusts the test year for an entry in the books made subsequent to the test period but reflective of the test period costs. RSA-17/OOP-4 removes a true up that was booked during the test period but reflective of 1992 costs.

Commission Staff objects to the Company's calculation of these two adjustments in two respects. First, Staff observes that the Company allocates the current tax portion of these true-ups at 41.9% to intrastate. Mr. Twitchell argues that these amounts should be allocated consistently with the underlying revenue and expense, approximately 72%, which would be similar to the allocation of other tax elements. The Company does not explain why there is such a discrepancy in the various allocators. It argues that it is difficult at best to determine the underlying revenues and expense. The Commission will adopt Staff's position on this issue because the Company fails to explain the discrepancy.

The second difference that Commission Staff argues is that the deferred tax adjustments related to pre-test year results should not be included in rate base. The Company contends that the Staff is making an inappropriate adjustment because all prior adjustments should be reflected in the account for end-of-period calculation.

Here, the Commission finds that the Company is correct. Using the end-of-period totals is appropriate, and the balance sheet is unaffected by the difference between an entry in 1992 and those in 1993.

F. Tax Effect of AFUDC, RMA-3

This Company-proposed adjustment is intended to restate the test year rate base and depreciation expense associated with Allowance for Funds Used During Construction (AFUDC) accrued in a side record related to short term Construction Work in Progress (CWIP).

Commission Staff proposes to offset the Company's adjustment with deferred taxes based upon its theory that depreciation of AFUDC must generate a reduction in deferred taxes. The Company responds that in order to have a tax effect of depreciation there must be revenue. It cites Ms. Wright's testimony that nonoperating revenues generated these deferred taxes, and it reasons that because the deferred taxes were "below the line", depreciation of the AFUDC cannot generate above-the-line deferred taxes. The Commission finds that the Company's explanation is correct.

The Commission accepts the Company's adjustment to its side record, which drew no objection, and finds that the Commission Staff-proposed adjustment to deferred taxes is inappropriate.

G. Interest Synchronization, C-16.

Public Counsel/TRACER witness Carver proposes an interest synchronization adjustment, generally referred to as pro forma debt in prior Commission orders, to pro form the effect of the Commission's authorized weighted cost of debt on the Company's Federal Income Tax (FIT) expense. His adjustment determines a level of pro forma interest by multiplying his pro forma rate base times Mr. Hill's weighted cost of debt.

Mr. Carver notes the absence of an interest synchronization adjustment in Staff's case. He states that it is important to adjust the interest expense effect on o the level of interest that the ratepayer is required to pay through the rate of return.

Staff accepts this adjustment in principle, with one modification. That modification is to include interest on CWIP as part of pro forma interest. Public Counsel/TRACER accept the Commission Staff revision for the inclusion of CWIP in the calculation.

The Company argues that it is inappropriate to use a hypothetical capital structure and therefore it is inappropriate to make a pro forma adjustment to interest. The Company's argument appears groundless. Even the Company's original weighted cost of debt was based on a capital structure and cost of debt from one point in time and not exactly equal to test year averages. Further, as Mr. Carver testified (TR 2416-2417), USWC had unamortized investment tax credit on its books during the test period. Investment tax credits are not subtracted from rate base, as are accumulated deferred taxes. USWC as an "option 2" company under tax regulations is allowed to earn its authorized return on the unamortized portion of these credits. The return is to be equal to the overall return found appropriate by this Commission. As Mr. Carver testified, the regulator is allowed to synchronize the tax benefits of the assumed interest costs allowed to USWC. Therefore, in order to represent correctly the tax benefits of interest to be paid for by the ratepayers, and allowed by current tax regulations, the Commission accepts Mr. Carver's proposed adjustment. The Commission has recalculated this adjustment based on the findings in this record, and the effect is an increase to NOI of $4,925,548.

Commission Staff proposed to include CWIP in the calculation of pro forma interest. The Commission notes that there is no testimony supporting Staff's modification. The Commission is aware that in many previous orders CWIP was included in the calculation to the extent companies were not required to capitalize interest for tax purposes. As there is no evidence to support this modification in this proceeding, it follows that the Commission will exclude CWIP from the calculation.

Excluding CWIP from the calculation raises the concern of how tax benefits of interest on construction will be flowed through to the ratepayers. In this proceeding only, the Company will be authorized to normalize the tax benefits of interest associated with CWIP, if they exist, by accruing AFUDC on projects when interest is not capitalized for tax purposes, at the authorized return net of tax rather than at the authorized return. This is the same method used to calculate the allowance for funds used to conserve energy (AFUCE) for Puget Sound Power and Light.[39]

H. Uncontested Adjustments

The following adjustments are uncontested and are accepted as portrayed: Adjustments RMA-1, 2, and 4 through 7; RSA-4, 6, 8, 9, 11, and 15; RSA 17-OOP-1, 3, and 5 through 8; PFA-12; and SA-10.

VI. RATE BASE

The parties disagreed on a number of matters relating to calculation of the Company's proper rate base for regulatory purposes. The differences are shown in the Table attached to this Order as an Appendix, as set out in Public Counsel's brief.

A. Working Capital, Adjustments PFA-3, PFA-4, PFA-5, & SA-7

The Company proposes three components of working capital: pension asset, cash working capital (lead lag study), and materials and supplies.

1. Pension Asset

The Company proposes to include the pension asset as a discrete item in rate base. Ms. Wright discusses the pension asset adjustment, PFA-3, which increases rate base by $69.9 million.

---

[39] See, WUTC v. Puget Sound Power & Light, Cause Nos. U-90-1183 and -1184, 3d and 4th Supp. Orders.

Ms. Wright says that the pension asset is created when the Company credits pension expense, because the pension fund is larger than the pension liability. This asset has been created since the Financial Accounting Standards Board (FASB) adopted SFAS 87, a statement of principle on pension accounting. The Company argues, as it did in Docket No. UT-930307, that credits to expense have been flowed through to the net operating income used in the sharing proceedings and general rate analysis.

Commission Staff opposes including a pension asset in rate base at all. It argues that the pension asset should not be allowed to earn a return twice, once in the pension fund and once in the rate base.

The Commission accepts the Company position on this adjustment. All of the return earned in the fund is used to reduce the need for further investment by the Company, and thus it works to reduce the pension expense. That was the Company's position in Docket No. UT-930307. The Company's proposal appears to be consistent with the prior order.. The order in that docket states that the Commission does not question the prudence of the asset, and that the reason for rejection at that time was merely that it should be examined in conjunction with a total working capital analysis such as the one presented in this proceeding.

2. Lead-Lag or Investor Supplied Working Capital Study

The Company proposes a lead-lag analysis to measure working capital. Ms. Wright's analysis, summarized in Exhibit 199 shows a negative working capital of approximately $5 million. However, when combined with the direct inclusion of the pension asset ($70 million) and material and supplies (PFA-5, $4.7 million) she contends that the total working capital at current rates is nearly $70 million. For comparison, Ms. Wright also presents a calculation of working capital using the approach accepted by the Commission in the most recent Puget Power general rate case. That analysis (see Exhibit 157) reveals a working capital of $135.6 million. This analysis was not performed on a total company basis but rather on a Washington State basis to be consistent with Mr. Cummings, the Company's cost of money witness.

Mr. Zawislak presents Commission Staff 's calculation of Investor Supplied Working Capital (ISWC), adjustment SA-5, which would replace Company adjustments PFA-3, -4, and -5, Pension Asset, Cash Working Capital, and materials and supplies. These adjustments are all related to the working capital issue. The Company included the pension asset and materials and supplies directly in rate base, and then calculated cash working capital through the use of a lead-lag study. Mr. Zawislak calculated working capital using the investor-supplied approach. His approach includes materials and supplies in working capital, but his calculation removes the pension asset from working capital and thus from rate base in total. The Company's calculation of total working capital is $70 million, while Staff's is a negative $46 million, for a difference in rate base of $116 million.

The major difference between the Company and the Commission Staff in working capital is related to Staff's exclusion of the pension asset, discussed above. The remainder of the difference is embedded in the calculations and the difference in methods. Mr. Zawislak also compares his ISWC approach to the method proposed as a check by Ms. Wright in her Exhibit 157, and contends that Ms. Wright's calculation is based on an incomplete Washington State balance sheet, that in fact does not balance. He contends that it is pieced together from different sources. His working capital calculation is based on total USWC financial statements.

The Company argues that the ISWC approach may be used only when Commission Staff demonstrates that a company's lead-lag study is inadequate. It contends that its ability to present the ISWC study is severely limited by the fact that USWC does not maintain jurisdictional balance sheets. It argues that the Commission Staff approach does not account for differences between jurisdictions in capital recovery policies, authorized rates of return, or taxation (contending that states that rely on sales taxes will have smaller working capital adjustments than states relying more on property taxes). It urges that the lead-lag approach will avoid the problems with the Commission Staff ISWC methodology.

Commission Staff argues that the ISWC methodology is superior because it provides a comprehensive review of all items in a total investor supplied working capital analysis, consistent with the Commission's January, 1995, order in Docket No. UT-930074, resolving USWC's petition to implement FCC and Financial Accounting Standards Board accounting for post-retirement benefits. Commission Staff contends that the Company analysis is incomplete and Ms. Wright's ISWC "test" is based on a hypothetical balance sheet that was not in balance prior to the calculation. It accepts lead-lag studies in concept, but opposes the Company's proposal.

The Commission accepts the Commission Staff approach to working capital in this proceeding. The Commission believes that it is more comprehensive and more accurate than the lead-lag approach. It allows the calculation to take place in the context of a balance sheet analysis of company performance rather than examining limited factors. While we understand the Company's situation, not having a readily available Washington balance sheet to work from, we believe that the additional accuracy gained from making the effort to prepare the balance sheet outweighs the expedience available in the lead-lag study. Consequently, we accept the Commission Staff methodology.

3. <u>Declared Dividends</u>

The Company contends that, if a balance sheet approach is used, the Commission must include declared dividends as an element of invested capital. It reasons that once dividends are declared, they are a liability owed to investors. It cites a leading accounting text in support of its proposition.

Commission Staff merely states that both Company and Commission Staff exclude declared dividends, citing USWC witness Mr. Haack as acknowledging that they are a short-term liability and that the funds are zero cost capital to the company.

The Commission accepts the Company's approach and views declared dividends as investor-supplied capital. The Commission notes that in many previous proceedings concerning other companies (for example, Puget Sound Power and Light), dividends payable were excluded from invested capital. The Commission by this order is not reversing those decisions. The circumstances and evidence provided in this record are different. Most notably, USWC is a subsidiary of USWI, and all dividends are thus payable to USWI at its discretion.

In summary on working capital, the Commission adopts Staff's method of calculating total working capital. The Commission rejects the Staff treatment of the $529 million pension asset as a non-operating investment. The Commission will treat the $96.8 million dividends payable as invested capital. As a result, total investor supplied working capital for USWC is $181 million. The Commission will directly allocate the $69.9 million pension asset to Washington intrastate operations. The resulting negative balance will be allocated consistently with Commission Staff's calculation in Exhibit 651, for a negative $37.8 million working capital allocated to Washington. The resulting net working capital is $32,119,086.

VII. Conclusion and Table

The following table sets out the results of the Commission's deliberations on net operating income and rate base elements.

Combined Table: Commission Results: NOI and Rate Base

VIII. Rate of Return

The Company's overall authorized rate of return is calculated by determining the interest rate that the company pays on debt and the investor's required return on equity, then multiplying those rates by the proper proportion of each source of capital in the Company's ratemaking capital structure.

The parties' positions at the conclusion of the proceeding are set out in the accompanying table.

COMPARISON OF RATE OF RETURN CALCULATIONS

	Company Cummings	Public Counsel Hill	Staff Folsom
SHORT TERM DEBT			
Ratio	10.267%	9.100%	9.100%
Cost Rate	6.170%	6.000%	5.390%
Weighted Cost	0.633%	0.546%	0.490%
LONG TERM DEBT			
Ratio	33.167%	38.900%	31.000%
Cost Rate	7.050%	7.200%	7.600%
Weighted Cost	2.338%	2.801%	2.356%
PREFERRED EQUITY			
Ratio	0.000%	0.000%	4.900%
Cost Rate	0.000%	0.000%	8.500%
Weighted Cost	0.000%	0.000%	0.417%
COMMON EQUITY			
Ratio	56.567%	52.000%	55.000%
Cost Rate	12.500%	11.250%	11.55%
Weighted Cost	7.071%	5.850%	6.353%
RECOMMENDED RATE OF RETURN	10.043%	9.197%	9.615%
NET OF TAX	9.003%	8.026%	8.619%

A. Cost of Debt

The calculation of cost of debt is rendered somewhat more complex by additional debt issues after the Company's original case was submitted, and by the Commission's acceptance of Mr. Hill's hypothetical capital structure.

The parties agree that the Commission Staff cost of debt should be used if the Commission accepts the Commission Staff-proposed approach to amortizing debt call premium. As we have done so, above, we accept the Commission Staff cost of debt here for the Company's original case capital structure.

We price the Company's recent additional debt at its actual cost, as derived by comparison of Mr. Cummings' direct and rebuttal presentations.

Finally, based on the total capital in Mr. Cummings' rebuttal case, less Commission Staff's adjustment for debt call premium, we add the additional debt required by Mr. Hill's hypothetical capital structure. We price it at Mr. Hill's proposed cost for new issues -- which is somewhat higher than the rate at which the Company was able to finance its recent issues.

The resulting long term cost of debt is 7.57%. We have adopted Mr. Hill's short term cost of debt at 6% as consistent with the Commission-determined capital structure.

B. Cost of Preferred

The Commission Staff proposed the use of preferred stock in a hypothetical capital structure, and offered a proposed rate. As described below, we accept Mr. Hill's hypothetical capital structure and include no preferred stock in the calculation of rate of return.

C. Cost of Equity

The Commission has reviewed the testimony on cost of equity that has been presented by the parties. We conclude that USWC experiences less risk than USWI and the other regional holding companies (RHCs). We believe that the effect of the lower risk can be measured through the cost of equity and/or the capital structure. The Commission accepts the arguments of Staff witness Folsom and Public Counsel/TRACER witness Hill that the extent of unregulated markets participated in by the regional holding companies creates a higher level of business risk associated with the total operations of the holding companies as compared to the regulated telephone operating companies.

The Commission rejects Mr. Cummings' proposal to use a group of non-telephone comparable companies. The Company's own case argues that Mr. Hill's use of gas distribution companies is not comparable. Those companies have lower bond ratings and higher debt ratios than are experienced in the telephone industry, facts that should tend to produce equity returns which are higher -- but as argued by Mr. Cummings and admitted by Mr. Hill, the gas companies are generally considered to have lower equity return requirements. So, too, the AA-rated industrial companies have capital structures with approximately 73% equity, yet their bond ratings are no higher than the bond ratings of USWC. The conclusion one draws is that these companies carry greater business risk, and it is difficult at best to conclude that the measurement of these companies' equity capital is comparable to that of USWC.

The Commission concludes, as represented by Mr. Hill, that the gas companies in his sample are of lower risk, and have lower equity return requirements than does USWC. The USWC equity cost rate should be greater than Mr. Hill's findings for this group.

The Commission rejects the use of the independent telephone companies as proposed by Mr. Cummings and Ms. Folsom. The Commission agrees with Mr. Hill that this group of telephone companies displays greater risk by their higher levels of penetration into unregulated markets. Further, the Commission is not convinced that the three-stage growth factor postulated by Ms. Folsom is appropriate, particularly as it relates to these independents.

The Commission finds the discounted cash flow results for the RHCs to be in the range of 11.73% as shown by Ms. Folsom, to 11.86%, shown by Mr. Cummings. As stated above, the Commission agrees with Commission Staff and Public Counsel/TRACER that USWC is of lower risk than the regional holding companies. However, for the most part we believe our authorized capital structure, discussed below, reflects this effect. We find an equity return range centered at 11.8% to measure investor requirements.

The Commission finds no reason to adjust this return for issuance costs as argued by Mr. Cummings. We find Ms. Folsom's arguments convincing that the real costs of issuance would only have a de minimis effect. The range of DCF results by each of the witnesses within the group of regional holding companies is far greater than any proposed effect for issuance costs. Finally, with all stock held by USWI, the actual issuance costs would be negligible.

The Commission finds that Ms. Folsom's range for the regional holding companies is from 11.0 to 12.7%; Mr. Hill's range for those companies is from 11.0 to 12.3% and Mr. Cummings' range is from 11.4 to 12.8%. Each of the witnesses shows a standard deviation of about 50 basis points for the study group's DCF results.

As discussed in the quality of service section, the Commission finds it necessary to provide an incentive for the Company to make improvements in its service quality, by adjusting the Company's authorized cost of equity capital to the lower end of the reasonable range. We find that a 50 basis point adjustment from the center of the range is appropriate to reflect the lack of quality customer service. The Commission thus finds an authorized equity rate of return for USWC in this proceeding of 11.3%.

D. Capital Structure

The Company urges the Commission to accept its actual capital structure of 56.6% equity and 43.4% debt. It contends that no party demonstrates that USWC 's capital structure is either unreasonable or uneconomical.

Mr. Cummings supports the Company's actual capital structure. He states that this capital structure is lighter in equity than USWC's target capital structure, but indicates that the Company is not likely to make great progress toward its target of 60% equity in 1995. He points out that this capital structure has more debt and less equity than the average RHC or independent operating company, around 41%.

Ms. Folsom for Commission Staff proposes to modify the Company's capital structure by adding preferred stock in place of some common equity. She contends that the capital structure needs to balance economic risks and costs of shareholder funding with those of debt funding. She states that this Commission has several times in the past adopted just that for USWC or its predecessor, PNB. She states that USWC's actual capital structure, with 59.9% equity, is too rich in equity. She points out that USWC's debt ratio is significantly below the required Standard & Poors AA bond benchmark of 42%, and further that USWC's capital structure includes no preferred stock, which is less expensive than common equity. She indicates that her hypothetical structure still includes a debt ratio of less than 42%. The use of preferred stock adds economy to the capital structure, she suggests, without increased leveraging. Further, Ms. Folsom rejects the concept of double leveraging, as she believes that the change in ownership of the operating company should not affect the cost of capital.

Mr. Hill also proposes a hypothetical capital structure, including 52% equity and 48% debt. He states that the company's actual capital structure, containing 56.6% equity, is excessively rich in equity. He identifies the following capital structures: USW Inc. has 47% equity in its capital structure; USWC regulated 60.29% equity; USWC double leveraged is 52.05%; Value Line Industrials have a 56.3% equity ratio; Value Line Gas have a 50% equity ratio (excluding short term debt); Value Line Gas and Electric are at 44% (before short term debt); and the RHCs have an average 50% equity ratio.

Mr. Hill contends that USW Inc., the RHCs, Value Line's industrial composite, and the independents used by Mr. Cummings in his estimate of common equity costs, all are entities with greater risk than USWC-Washington regulated activities. He argues that the in each case, the companies participate in substantially more competitive markets than the USWC regulated Washington operations. He argues that monopoly utility services are perceived as lower risk and the investor requires a lower return than similarly debt rated entities. While Mr. Hill agrees with Staff witness Folsom that the use of a double-leveraged capital structure is not proper, he notes that Ms. Folsom does not analyze impacts of leveraging. He argues that a holding company, such as USW Inc., can financially cross-subsidize its more competitive (therefore more risky) ventures by including more equity in the regulated operation than necessary for the efficient financing of the regulated operations. He points out that on a regulated basis a 60% or even a 56% equity ratio is substantially higher than the consolidated USW Inc.

equity ratio of 47%.

Mr. Hill also looks to the gas industry which, he argues, faces similar risks to those faced by local exchange companies. Despite these similarities, Mr. Hill does not believe that gas distribution companies are perceived to be as risky as the telecommunications industry.

Public Counsel/TRACER argue that Mr. Cummings recommends the use of an actual capital structure without performing an evaluation of the most basic standards: Safety and Economy. They argue that Mr. Hill did present evidence that his recommendations would produce reasonable results. They argue that the Earnings Before Interest and Taxes Plus Depreciation and Amortization (EBITDA) studies are theoretically valid, noting that the company has placed some reliance on EBITDA themselves. They point out that Public Counsel is not recommending $35 billion in debt, but note that the study indicates the level of safety being experienced by USWC even at a 60% debt ratio. Finally, they argue that the benchmarks of the rating agencies are advisory not absolute.

Mr. Hill cites the gas company equity range of 44-47% to be below the proper ratio for the telecommunications industry and establishes the 47%, also USW, Inc.'s consolidated equity ratio, as the bottom of the range appropriate for a local telecommunications company. He argues that top of the range should be significantly below the Value Line industrials average equity ratio of 56%. He identifies the 52% regulated leveraged equity ratio used to finance USWC and uses it as the top of the range. In this proceeding he chooses the 52% as the acceptable equity ratio. After identifying the 52% equity ratio, Mr. Hill goes on to demonstrate the safety of his proposed capital structure through comparison of earnings before interest and taxes to the company's total interest expense. His comparison also includes interest as if the Company had been only 40% equity financed.

Mr. Hill states that the use of preferred stock, as proposed by Ms. Folsom, does not achieve the desired goal that she stated. He indicates that while the market cost is similar to long term debt rate, the tax implications make preferred substantially more expensive than debt. He also states that the use of preferred stock is not common in the telephone industry.

Mr. Cummings opposes Mr. Hill's proposed capital structure. Mr. Cummings contends that Mr. Hill's reliance on financial reporting capital structures is inappropriate, and that the use of the financial reports is not in agreement with the investment used for ratemaking. He argues that Mr. Hill's proposed capital structure is inconsistent with the risk associated with the company's AA bond rating and looks more like an A or BBB rated company. Mr. Cummings argues that Mr. Hill's cross-subsidization argument uses inconsistent data, namely financial reporting for U S WEST, Inc, versus regulatory structure for USWC. He also argues the reverse, that is, use of Mr. Hill's capital structure, may result in cross-subsidization of USWC. With respect to Mr. Hill's safety analysis, Mr. Cummings states that the results simply produce unreasonable results. He argues that the level of debt ($35.5 billion) assumable under Mr. Hill's analysis would produce results that could not be considered financially safe by rating agencies or investors.

The Company argues that Mr. Hill's references to financial reporting capital structures of his comparable companies is improper and that regulatory capital structures should have been used, instead. Public Counsel/TRACER respond that the regulatory capital structure is 52% equity, adjusted for parent company leverage, is an example of the excess of the company's actual structure.

Conclusion: In reviewing capital structure,

> The Commission's function is to set as the appropriate capital structure for ratemaking purposes that structure which best balances economy with safety. (WUTC v. Continental Telephone co. of the Northwest , Cause No. U-81-14, 2d Supp. Order (1981).)

The Commission accepts Mr. Hill's analysis and his proposed hypothetical capital structure. We find that Mr. Hill's proposal best balances safety with economy. We find that the existing capital structure is unreasonable and unwise for the company and that it so unreasonably and substantially varies from usual practice as to impose an unfair burden on the consumer.

We find it significant that US WEST Inc can set the Company's capital structure at whatever level best fits with its larger corporate objectives, rather than whatever is the best balance between debt and equity for both business and ratepayer concerns for USWC as a stand-alone company.

Mr. Hill's proposal is supported by comparable data and it is shown to be both economical and safe by earnings volatility tests.

E. Commission's Rate of Return/Capital Structure

Type of Capital	Ratios	Cost Rates	Weighted Costs
Long term debt	38.9000%	7.570%	2.945%
Short term debt	9.100%	6.000%	0.546%
Preferred equity	0.000%	0.000%	0.000%
Common Equity	52.000%	11.300%	5.876%
TOTAL	100.000%		9.367%

IX. Revenue Requirement Determination

Pulling together the financial elements of this Order, the following table shows the calculation of the Company's revenue requirement.

In calculating the Company's revenue requirement, it is necessary to use a conversion factor to account for such factors as taxes, to derive the number of pre-tax revenue dollars needed to produce the required net operating income. The parties' briefs do not state that there are disagreements as to the appropriate conversion factor to use. Consequently, we use Mr. Hua's proposed factor in this calculation.

Derivation of Revenue Requirement

Pro Forma Rate Base	$1,561,793,482
Authorized Rate of Return	9.367%
Return Requirement	$ 146,293,195
Pro Forma Net Operating Income	$ 204,749,579
Net Operating Income Deficiency (Surplus)	($ 58,456,384)
Conversion Factor Multiplier	1.565458
Revenue Deficiency (Surplus)	($91,511,013)

PART FIVE:

RATE DESIGN ISSUES

I. Policy

The parties agree that the policy factors that are most significant are those set out in Chapter 80.36 RCW, especially those in RCW 80.36.300.[40] The Commission keeps those factors in mind as it reviews the issues and makes its decisions on individual elements of this proceeding and on this matter as a whole. In particular, the statutory goal of universal service is a significant element of Washington State policy goal. It underlies many of the parties' arguments. particularly those of Public Counsel/AARP for achieving low residential exchange rates. USWC has contended that universal service may be maintained despite substantially higher residential local exchange rates than exist at present.

Universal service remains a primary and continuing Washington State policy. The Commission notes the existence of a pending docket aimed specifically toward exploring the meaning of universal service in a changing economic and regulatory environment (Docket No. UT-950724). The Commission will make no close examination of universal service in this proceeding. First, the other cause is pending and its scope will go substantially beyond the issues as they are framed in this matter, and second, by virtue of the revenue reduction that we find to be required we are not faced with rate increases that might threaten the existing universality of local exchange service. The topic will be addressed in the pending proceeding.

The principal policy issue that the parties chose to address is competition -- the role of competition in transitional regulation, the correct response of a regulated utility to encounters with competition, and even whether "competition" as each party defines it exists.

Throughout the proceeding the Company has contended that it is beset with

---

[40] The statute reads as follows:

80.36.300 Policy declaration. The legislature declares it is the policy of the state to:

(1) Preserve affordable universal telecommunications service;

(2) Maintain and advance the efficiency and availability of telecommunications service;

(3) Ensure that customers pay only reasonable charges for telecommunications service;

(4) Ensure that rates for noncompetitive telecommunications services do not subsidize the competitive ventures of regulated telecommunications companies;

(5) Promote diversity in the supply of telecommunications services and products in telecommunications markets throughout the state; and

(6) Permit flexible regulation of competitive telecommunications companies and services. (1985 c 450 § 1).

competition on all sides and that the Company should be permitted to set prices as though marketing issues were the predominant criteria. Time and again, it supported proposed pricing not by factors involving cost, but by factors involving marketing.

The Company contends that the goals of this proceeding are to establish a realistic revenue requirement for USWC and to rebalance rates to reflect competitive realities. The Company argues that need exists now, not in the future, and it contends that failure to respond is potentially unlawful and confiscatory. It bases its rate restructure principally on the need to meet market requirements.

Commission Staff, however, responds that USWC vastly overstates the existence of and near term prospects for competition. It urges that the level of competition that exists today is not strong enough to substitute for regulation in constraining prices and providing customers choices.

Commission Staff cites Mr. Selwyn's suggested goals for the transitional environment: (1) minimize duplication by requiring resale and unbundling; (2) promote entrants' efficient use of the existing network; (3) promote development of networks through private investment so competitors have comparable risks and rewards; (4) promote greater responsiveness to specialized needs than feasible for a single provider -- i.e., encourage "niche" providers. The Commission finds that these goals are appropriate, and it has considered them in its rate design deliberations.

Public Counsel/AARP contend that the Commission should "expose the fiction" that residential rates are subsidized, and make a specific finding that residential rates are not subsidized. The Commission believes that the evidence is overwhelming that local exchange service does cover its total service long run incremental costs (TSLRIC) -- even as calculated by the Company in its Average Service Incremental Cost (ASIC) presentation -- and makes that clear in its discussion of residential rates, below.

Public Counsel/AARP contend that USWC has alleged that it faces competition but that it has not presented objective evidence on market share, market power, or the existence of price-constraining competition. The Commission finds this to be true, and it observes that this is one of the central factors in the result of this proceeding. It is uncontested that some entrants are preparing to provide or are providing competitive services. It is also uncontested that the future holds many unknowns. Cable television providers may package two-way telecommunications with one-way programming services. Wireless services may supplant rather than supplement wire-based communications in the future. Internet-based services may provide a viable alternative to measured toll service. The future presents a multitude of options, any or many of which may ultimately take a significant share of the Washington State telecommunications market.

But USWC has presented no credible evidence that the future is upon us to the extent that we may shift regulatory focus from costs to market-based pricing. USWC made no showing that the nascent competition of which it presented anecdotal evidence has the power to constrain prices. The Commission anticipates that at some point, it will indeed be necessary to shift regulatory focus from costs to market prices -- but that point requires the existence of effective competition that can constrain prices. USWC can achieve a shift toward market pricing by securing competitive classification of particular services through the statutory mechanisms for doing so -- which requires a demonstration that the service is subject to effective competition. The Company could negotiate or seek approval of an AFOR in which pricing flexibility is granted and earnings regulation relaxed as part of a larger agreement.

We are sensitive to USWC's situation and its concerns. We find our Order to be consistent with the transitional market that now exists and with sound preparation for competitive markets. We also will authorize the Company to file banded rates for any service that it believes is likely to face competition. Banded rates provide as much pricing flexibility as the law -- and our duty to protect captive customers -- permit. See, RCW 80.36.340.

Public Counsel/AARP ask the Commission to end USWC's use of "black box" cost studies by announcing a number of specific cost study requirements; the Commission will address those matters below.

The Department of Defense/Federal Executive Agencies (DOD/FEA) argues that the federal government needs viable competitors for its contracting policies to work effectively to save the government money. The Commission believes that its actions in this order do promote the development of effective competition in a way consistent with both State and Federal law. DOD/FEA cite to the recently-enacted Federal Telecom Act and its role in advancing implementation of effective competition for local exchange service.

The Washington State Department of Information Services argues that the Commission should promote competition (or at least do nothing to hinder competition). Again, we believe that our actions are consistent with advancing competition in a way consistent with law and all parties' rights. WITA, the Washington Independent Telephone Association, asks the Commission to consider policy choices from the perspective of all players so that clear and appropriate signals are sent. We have done our best to do so in this Order.

II. Cost Studies

This case is the first in which this Commission has attempted to measure on a systematic and consistent basis the costs incurred by USWC to provide various services. There has been remarkably little debate about the need to measure service-specific costs as one element of determining reasonable and sufficient rates. Nor has there been great disagreement that costs should be measured from the ground up, i.e., on a long-run, incremental, going-forward basis and without consideration of the actual costs incurred in the past by USWC.

The degree of consensus about the need to do cost studies and the need to do them on a long-run incremental basis is in stark contrast with the lack of consensus about the specifics of the cost calculations. Parties disagree about virtually every aspect of the cost study process, notably about what constitutes an incremental cost, what costs should be included in a study, and what analytical model should be used to calculate costs.

In addition, while there is general agreement about the need for studies, there is substantial disagreement about what should be done with cost studies. The parties do agree that rates for individual services should not be set below incremental cost so as to have one service subsidizing another service. Many parties identify particular services that they believe should be priced at or very near incremental cost. Some parties acknowledge, and the Commission finds, that setting all rates at incremental cost would not produce enough revenue to meet USWC's revenue requirement, which is determined on the basis of its embedded costs. Except for USWC's flawed Average Direct and Shared Residual Cost (ADSRC) calculations, no party offers a systematic approach to reconciling the revenue requirement of the firm with the incremental costs of individual services.[41]

To address the contested issues regarding methodology and cost study inputs, it is important first to state clearly the purpose to which the end product will be put: The Commission will use incremental cost studies primarily to establish price floors for individual services. When USWC introduces a new service or seeks to lower the rates for an existing service, it is important to ensure that the rates at least cover the incremental costs of providing that service. Guarding against cross-subsidy and predatory pricing is the primary function of the incremental cost studies.

The Commission will use incremental cost studies secondarily to guide and inform its decisions on rate spread in this case. No party has suggested any sort of mechanistic relationship between incremental costs and rates, such as an equal percentage markup over incremental costs, and any such formula would appear to be inappropriate. It could, for instance, result in rates for some services that would exceed the revenue-maximizing level. It would be foolish to set rates so high that the service actually produces less revenue than it would at a lower rate. Neither are rates based on equal markup over incremental cost necessarily fair. An equally "fair" rule, with potentially very different rates, would be to have equal discounts from the stand-

---

[41] The record also is silent as to the appropriate price ceilings for various services. Incremental costs provide a theoretical price floor for each service: the price of a service should at least equal the costs that the firm would not incur if it were to cease providing the service. If prices are set lower than incremental cost, other firms could be prevented from entering the market, even if they have lower costs than USWC. The price ceiling, by contrast, would be defined as the costs that a firm would incur if it were to provide a particular service on a stand-alone basis. Local exchange service, for example, should not be priced above the cost of building a stand-alone network of loops and switches dedicated solely to local service. Public Counsel argues that the price ceiling for local service is obtained by including the local loop in the cost of local service. The Commission does not accept this argument, because it assumes without factual basis that other shared and common costs would be avoided in a local-only network.

alone cost of each service.

Incremental cost studies provide one more useful tool in determining fair, just, reasonable, and sufficient rates for individual services, but they do not in themselves determine those rates. Other considerations, such as the traditional factors discussed by TRACER,[42] remain an important part of the rate-setting process.

A. Methodology

USWC's cost studies measure Average Service Incremental Cost (ASIC), Shared Residual Cost (SRC), and Average Direct and Shared Residual Cost (ADSRC). The main points of contention are whether and how to account for shared costs; whether to include the cost of the loop in the incremental cost of one or more services; and what analytical model to use.

The Commission finds, consistent with the presentations of most parties that addressed cost issues, that the appropriate measure of costs is Total Service Long Run Incremental Cost (TSLRIC). The Commission has found this measure of costs to be appropriate in prior cases.[43] Incremental costs are appropriate because they measure the additional costs that are incurred by providing an additional service. TSLRIC therefore represents the economic price floor. If the revenues from a service exceed the TSLRIC of that service, then that service is not being cross-subsidized. If the firm were to stop providing that unit, its revenues would fall by more than its costs.[44]

1. Inclusion of Shared Residual Costs

The Commission rejects the concept proffered by USWC of incremental costs that include what it labels variously as "shared," "family," or "group" costs. USWC's cost studies measure Average Service Incremental Cost (ASIC), Average Shared Residual Cost (ASRC) and Average Direct and Shared Residual Cost (ADSRC) in the following relationship:

---

[42] The cited elements are the following:
1. Effectiveness in yielding total revenue requirements under the fair return standard; 2. Fairness in the apportionment of total costs of service among different consumers; and 3. Efficiency in discouraging wasteful use of services while promoting all justified types and amounts of use, in view of the relationships between costs incurred and benefits received.

[43] Notably, these are the orders in the "term loops" case, 4th Supplemental Order, Docket No. UT-930957, et al., and in the Interconnection case, 4th Supplemental Order, Docket No. UT-941464. The Commission acknowledges that the latter order remains involved in post-order process.

[44] Having prices exceed their respective TSLRICs is a necessary but not sufficient condition in determining whether those prices are fair, just, reasonable, and sufficient. That determination requires consideration of a much broader set of factors than the TSLRIC of the service.

$$ADSRC = ASIC + ASRC$$

The Commission agrees with Staff, Public Counsel, and others who argue that ADSRC is not a relevant measure of the economic cost of providing a service. ASIC is the element in USWC's studies that most closely approximates TSLRIC. Inclusion of SRC in incremental cost results would allow USWC to manipulate costing concepts to suit its pricing purposes. It could assign more of the shared costs to services that have captive customers.

USWC contends that ADSRC, while not the economic price floor, is a useful measure for setting prices of individual services. It urges that pricing at ADSRC ensures the recovery of shared residual costs from the group of services that share the SRC. It contends that under almost no circumstance should a service be priced at ASIC, the theoretical price floor. If the Commission chooses to ignore the ADSRC in declaring cost floors, argues USWC, the shared and common costs must nonetheless still be recovered in prices.

The Commission agrees that shared and common costs, if they qualify as a part of the Company's revenue requirement, must be considered in setting rates. It does not follow, however, that doing so requires that rates be set at ADSRC. The ADSRC value may be useful to USWC's management as a pricing target, and there is nothing wrong with its use as a management tool when it prices unregulated services. It should not, however, define either the floor or the target for regulated ratemaking.

2. Inclusion of the Local Loop in Incremental Cost Studies

USWC includes the cost of the local loop in its calculation of the TSLRIC of local exchange service. According to USWC, allocation of any loop costs to access and toll service violates the principle of incremental costing, because the entire loop cost would exist even if no carrier access or toll services were provided.

Public Counsel/AARP argue that USWC has significantly overstated the incremental cost of local exchange service by including the cost of the local loop, which they assert is not incremental to local service. Their argument is that the loop would be required to offer virtually every other service besides local exchange service and, therefore, that the cost of the local loop is not incremental to local exchange service. Since the loop is required if USWC is to provide any one of toll service, access service, or local service, it is incremental to none of the services.

The Commission finds, consistent with the presentations of Public Counsel/AARP, and other parties that the cost of the local loop is not appropriately included in the incremental cost of local exchange service. The local loop facilities are required for nearly every service provided by the Company to a customer. Neither local service nor in-state long distance service nor interstate long distance nor vertical features can reach a customer without the local loop. Should USWC cease to provide any one of these services, its need for a local loop to provide the remaining services would remain. The cost of the local loop, therefore, is not incremental to any one service. It is a shared cost that should be recovered in the rates, but no one service is responsible for that recovery. USWC's presentation that the local loop is appropriately and necessarily an element of the cost of local exchange service, made through the testimony of witness Farrow, is not credible in light of the purposes of a long run incremental cost study and is inconsistent with accepted economic theory regarding such studies.

USWC argues that allocation of any loop costs to access and toll service violates the principle of incremental costing, because the entire loop cost would exist even if no carrier access or toll services were provided. This argument addresses why loop costs should not be included in the incremental cost of toll and access, but it does not explain why they belong in the incremental cost of local service. The argument applies equally well in application of the costs to local exchange service. Indeed USWC's brief supports the principle that the loop is a shared cost rather than the direct cost of any one service:

> All multi-service firms have shared and common costs by definition, but they are particularly significant for a LEC, which offers very capital and expense intensive local services which require a separate loop from the central office to every premise in its service territory... (USWC brief, 11).

Our conclusion that the local loop is correctly treated as a shared cost is consistent with the testimony of USWC's cost witness Brian Farrow, who testified:

> U S WEST recommends that the Commission deal with the recovery of loop costs as a pricing exercise. The loop costs calculated in U S WEST's cost studies calculate the loop costs as though the loop is the cost object. The recovery of those costs is a pricing exercise. (Ex. T-338, p. 14).

Commission Staff offered a different approach to the treatment of loop costs in incremental cost studies. Staff argued that the cost of the loop should be allocated to services that use the loop based on a formula adopted by the Commission in Docket No. U-85-23. In that case the Commission said that loop costs should be recovered 25% from interstate toll, 16.95% from intraLATA toll, and the remainder, 58.05%, from local service. Thus staff's calculation of the incremental cost of local service includes 58.05% of the cost of the local loop. Commission Staff argues that the loop costs are not part of the incremental cost of local exchange service but are allocated to local exchange and toll service because of the Commission's past orders. Staff contends that the assignments adopted in U-85-23 were reaffirmed in the recent interconnection order, where the Commission said:

> [T]he residential cost study contains a basic flaw: USWC improperly allocates 100% of the local loop to residential service,

> and 0% to services that rely and depend on the use of that facility. The Commission in the past has addressed this issue and found it appropriate to allocate a portion of the loop costs to toll and other services. See, Eighteenth Supplemental Order, Cause No. U-85-23, et al (December 1986). Vertical services such as call waiting, or any other services that use the loop, should receive an allocation of the loop's costs.]Fourth Supplemental Order, Docket No. UT-941464, p. 39.]

Staff reads too much into this section of the Interconnection order. The question before the Commission in that case was whether residential local exchange service was priced below its incremental cost. In the quoted passage the Commission merely noted that the Company had made an error in its calculation by including 100% of the loop cost but less than 100% of the revenues derived from use of the loop. Based on the decision in U-85-23, one should not expect local service to be expected to cover 100% of loop costs, because some loop costs had been assigned to other services. The issue here is much broader and should not be controlled by the assignment provided for in U-85-23.[45]

3. Choice of an Analytical Model and Documentation for that Model

USWC submitted incremental cost studies that were developed using various in-house cost models. The manuals alone for these models (Ex. 340) are about 1 1/2 inches thick. Other parties have criticized USWC for lack of adequate documentation and access to these models, as well USWC's use of proprietary data in the models. AT&T goes beyond merely saying that USWC should do a better job with its models and argues that the Commission should take cost studies out of USWC's hands:

> The Commission should rely instead on independent studies that use publicly available information. In sharp contrast to the impenetrable maze presented by US WEST, such studies employ transparent methodologies to evaluate verifiable, nonproprietary data. (AT&T rate design brief, 11).

[45] The allocation factors proposed by Staff can be likened to the ADSRC methods proposed by USWC. Both approaches provide a mechanism for allocating shared costs such as the local loop to individual services for pricing purposes. Neither approach yields the economic price floor or accurately measures the incremental cost of a service. Even as a pricing principle, either method would produce arbitrary results that do not reflect either competitive realities or the public policy considerations that should guide the setting of individual rates.

AT&T suggests the Hatfield Model as the nonproprietary replacement for estimating the cost of basic local telephone service.[46] The Hatfield Model uses publicly-available (that is, non-confidential) cost information from USWC and other sources, and it incorporates elements of the Benchmark Cost Model that has been presented to the FCC by USWC and others in the context of universal service funding.

MCI also suggests the Hatfield Model "deserves serious attention by the Commission." TRACER recommends that the Commission consider in the future use of the Hatfield Model. Neither Staff nor Public Counsel address the merits of the Hatfield model, but both parties criticize USWC's approach as a "black box" whose operation is not understandable.

USWC opposes use of the Hatfield model to estimate the incremental cost of its local service, arguing that its methodology and inputs are invalid. The model was designed to identify geographic areas that are expensive to serve, USWC argues, not to estimate the average cost of serving all areas. USWC argues that AT&T has not provided documentation for the model and has not justified much of the data used as inputs. Another problem, USWC contends, is that the model uses embedded costs in some cases.

AT&T responds that the model is publicly available; indeed, it uses an intermediate Benchmark Cost Model whose developers include USWC. AT&T argues that the study's incremental cost calculations use as much USWC-specific data as is publicly available, and that this reliance on publicly available data represents a strength of its approach, since the results can be audited more easily. The Commission agrees. Every cost number supplied by USWC has been marked "confidential." Using USWC's estimates therefore requires that we set rates without the ability to tell the public the costs on which those rates are based. In some cases that secrecy may be necessary, but it certainly should be avoided where reasonable alternatives exist.

The Commission rejects USWC's cost studies for local service and the local loop. The most reasonable and accurate measure of incremental cost for these services on this record is provided by the Hatfield model sponsored by AT&T. While USWC complained that the Hatfield Model is inaccurate as to USWC, it provided little verification of its claim. We are satisfied from comparisons of underlying assumptions and comparisons of inputs that it accurately reflects costs incurred by USWC and that, if it errs, it likely errs on the high side through the inclusion of an overhead factor. Correcting the USWC local exchange model with the tools and input available also provides verification for the Hatfield model.

For other services, no party offered an alternative to studies prepared using USWC's models. The USWC models for services other than local exchange, without shared costs and with appropriate inputs as discussed below, are not precise but are sufficient for reference purposes to estimate incremental costs of services other than local exchange service

46 See, Ex. 760-T, pp. 4-17; Exhibits 761-T, 762, 763, 764, 765-T, 766, and 767.

and the local loop.

4. Overhead Factor

Commission Staff proposes to increase all incremental cost values by an "overhead factor" of 16.41%. The Hatfield Model sponsored by AT&T includes an overhead factor of 6%. Incremental costs usually do not include overhead or administrative costs of the firm, recognizing that those costs will be incurred regardless of whether a particular service is offered. Staff argues that overhead costs actually are sensitive to the number of services being provided. There may be merit to the Staff concerns, but the solution is to identify those costs and include them directly in incremental costs rather than impose an across-the-board multiplier on all results. Moreover, the use of such a factor would suggest more precision than actually exists in the cost study results, which are at best estimates of the actual incremental cost of providing each service. The proposal to inflate incremental costs by an overhead factor should be rejected.

B. Inputs

Some disagreement involved the propriety of various elements of data to be considered (called "inputs") in an appropriate study.

1. Depreciation Rates

The Commission has determined that for regulatory purposes, cost studies should use the depreciation rates prescribed by the Commission. USWC submitted cost studies with greater depreciation expenses, i.e., faster depreciation. Staff, Public Counsel and others argue that USWC should use the economic lives prescribed by the Commission in setting the company's depreciation rates. The parties appear to agree that incremental cost studies should reflect the economic life of the facilities. Their disagreement centers on whether the Commission's depreciation rates reflect the best estimates of economic life (as Staff claims) or a policy of understating depreciation in order to hold down current rates (as USWC claims).

USWC argues that the prescribed depreciation rates are outdated (three years old) and based on backward-looking historical data. USWC says the Commission already decided in the interconnection order that real, current expense inputs should be used in cost studies.

According to Commission Staff, however, "The (Commission-)prescribed lives are economic lives, they are just not the economic lives the Company wants." (Commission Staff Rate Design brief, p. 13). Staff's argument is correct.

The Commission determines appropriate depreciation rates for regulatory purposes on a frequent basis. As noted in a prior Order in this proceeding, the Commission has just completed a review of depreciation methodology and rates and has approved changes. The Company has sought judicial review of that decision and although now on remand to the

Commission, review is not complete. Other depreciation groups will be reviewed very soon in a collaborative procedure called "represcription" involving representative s of the Company, the Commission Staff, and the Federal Communications Commission. That process, which recurs every three years, is now beginning and according to the record it is typically completed swiftly. The depreciation rates challenged by the Company are rates that were considered in the prior proceeding or are subject to review in the represcription process. The Commission finds that the authorized depreciation rates are proper for cost study use and that they sufficiently reflect USWC's costs that they may be used in an accurate cost study and for ratemaking purposes. We see no reason to approach matters on a piecemeal basis, litigating matters incessantly, when it is both functional and appropriate to make a single and consistent timely determination of appropriate depreciation rates for all regulatory purposes. The function of depreciation, estimating the actual economic lives of physical properties, is identical in every instance. It is far better to have a single consistent and timely approach to depreciation than to relitigate it unnecessarily.

2. Cost of Money

In the interconnection case, Docket No. UT-941464, the Commission determined a forward-looking cost of money may be appropriate for use in a cost study. Parties do not appear to disagree with this principle, though their opinions vary on the right estimate of cost. In addition, Public Counsel argues that using the last-authorized rate of return could provide stability and prevent relitigation of cost of money in rate design cases. The Commission agrees that any theoretical advantage to using "pure" forward-looking values would be more than offset by the practical problems of turning every cost-based rate filing into a cost of money case. The last authorized rate of return provides a reasonable measure of the cost of money for this purpose and will be accepted as an appropriate principle.

3. Fill Factors

"Fill factors" describe the amount of unused capacity that will be included in the cost of a particular service. USWC argues that actual fill levels are often below the objective or planning level and that using objective fill factors would cause the cost of spare capacity necessary to provide a particular service to be treated as a shared cost of all services. USWC says the use of objective fill understates the true cost of particular services and that actual fill factors should be used instead. Staff and Public Counsel have presented evidence that actual fill factors would produce excessively high estimates of incremental cost.

The Commission has previously ordered USWC to develop cost estimates using objective fill factors, and we will continue to require the use of objective fill. In situations where capacity is being underutilized, incremental cost calculations would include costs of capacity that is not required to provide that level of service. That would be inconsistent with the theory that incremental cost studies should be prepared on a forward-looking basis and without respect to the actual costs incurred in the past. Using objective fill will assign a reasonable portion of unused capacity to individual services. The remaining unused capacity is most appropriately treated as a shared cost. This issue ultimately has no effect on whether USWC recovers the cost of this unused capacity, since shared costs also are recovered in rates.

4. Wire Pairs in Residential Loop Cost

USWC's cost study for residential exchange service and the residential loop includes the cost of three wire pairs. USWC includes only a single pair in the cost of a business loop. Only one pair (plus a fraction to allow for bad wires, which is accounted for in the objective fill value) is required to provide service. Staff and Public Counsel argue the three-pair assumption overstates the cost of a residential line. Additional pairs are installed only because USWC expects residential customers to order additional lines. The Commission so finds. The cost of the additional pairs should be matched with the additional-line service for which they are installed and should not be included in the cost of the first line.[47]

5. Weighting of Design Types

The USWC cost studies do not estimate the cost of every possible combination of loop lengths, switches, etc. Instead, costs are developed for several designs, and these are weighted to arrive at an overall number for incremental cost of average service. Public Counsel argues that the weights are based on judgment and not properly documented. Public Counsel contends that USWC was unable to show how the actual distribution of access lines matches with its design types. USWC's cost witness, Mr. Farrow, responding to questions from the bench, said that the weighing is based on an analysis of Washington state data.

The Commission accepts USWC's explanation for this proceeding. However, it is an example of the more general and continuing problem relating to documentation and auditing of USWC's cost studies. Other parties *must* be able to verify USWC's results if the company's cost studies are to be relied upon in setting regulated rates. Parties have provided specific recommendations as to how USWC can improve its documentation. Until those improvements are made, the Commission will limit its reliance on USWC's results and will encourage parties to sponsor alternative results such as those of the Hatfield model.

C. Results

The most important question to be answered by cost studies in this case is whether residential local exchange service is being cross-subsidized by business and toll service. USWC argues that this cross-subsidy exists and is undermining its ability to remain competitive. Other

---

[47] The three-pair error has no direct bearing on the decisions of this case, because the Commission has already rejected USWC's entire residential exchange service and local loop cost study in favor of the Hatfield model results. This error was one factor in the Commission's decision to rely on the Hatfield model results. US WEST's argument that it will be grievously deprived of its rights and its opportunity to recover its costs if the additional pairs are deemed shared or common rather than incremental costs in its cost study is silly, as the Company is allowed under regulation to recover both its shared or common costs and its incremental costs.

parties, including Staff, Public Counsel, TRACER, MCI, and AT&T, argue that the residential local service rate covers its incremental cost.

The evidence clearly shows that residential service is covering its cost. The incremental cost of local exchange service is approximately $4.42. This amount is calculated by subtracting the Hatfield model results for loop cost ($8.96 [Ex. 765-T, 4]) from the Hatfield model results for the total cost of local service ($13.38 [Ex. 767]), using the modified fill factors. These values are only approximate, in part because any model result is only approximate and in part because the Hatfield model results do not necessarily reflect the input values determined earlier to be appropriate.

The conclusion to be drawn from these cost results is that residential service does not receive a subsidy at current rates. The average residential customer today pays $10.50 for local service and EAS adders, plus a subscriber line charge of $3.50. If USWC were to exit the local residential exchange market, its revenues would decrease by $14.00 per customer, and its costs would decrease by about $4.42 per customer. Not only does residential service cover its incremental cost (the test for cross-subsidy), it even covers the incremental cost of the local loop that is used to provide local, long-distance, and vertical services, since the revenue from local service, including the subscriber line charge, exceeds the $13.38 cost of local service plus the local loop.

III. Cost/Revenue Requirement Relationships

The parties generally agreed that rates should be based on, but not necessarily equal to, long-run incremental cost. There also was a consensus among those addressing the issue that the Company's revenue requirement will require that rates be set above TSLRIC. No party proposed a specific method of establishing a relationship between prices and incremental costs that could apply across all services.

The price/cost relationship under existing rates for most USWC services is summarized by the Company in confidential Exhibit 485-C. USWC contends that Ex. 485-C shows the relationship between incremental cost and revenue for most USWC services. Currently, the Company argues, toll and business basic exchange service contribute more than 100% of USWC common costs. These services are at competitive risk, says USWC, and toll revenue is declining. The Company cites asserted problems with rates for residential services, Directory Assistance, and Terminal Loop services. It contends that, even with its proposed rebalancing, switched access and basic business local exchange service would subsidize other services.

Commission Staff argues that Ex. 485-C does not show what level of overall markups would apply on average to reconcile incremental costs with revenue requirement. They note that the exhibit contains outdated data on switched access revenue, is only a preliminary analysis, does not use consistent methodologies and inputs, assigns all residential loop costs to local service, and accounts for services providing less than 95 percent of revenues. In addition, Commission Staff argues that it did not have adequate opportunity to assess the support for the information. It argues that even according to the exhibits, both toll and local rates are above TSLRIC.

Public Counsel/AARP acknowledge that even with its flaws, Ex. 485-C shows that USWC must price above Total Service Incremental Cost (TSIC) to earn a fair return. Properly interpreted, however, Public Counsel contends that the exhibit shows that residential rates exceed TSIC.

The Commission finds that many problems with this exhibit limit its usefulness. It was filed very late in the case; it was revised repeatedly; it does not include all services; and costs are not calculated on a consistent basis. Loop and local exchange costs are based on the USWC study that we reject in this order. With those limitations in mind, however, we find that it does provide a general sense of the relative levels of contribution of various services. Within the context of this proceeding the data in it can provide a useful guide for rate spread decisions, as long as limitations of the data are kept in mind.

The Commission will not attempt to set an equal markup of prices over the incremental costs of various services. That is neither required by competitive pressures nor generally practiced in unregulated markets. It could well produce illogical and uneconomic results, such as some services being priced above market level, causing USWC to exit a market it could efficiently serve if competitive alternatives are or become available.

Examining the relationships between a particular service's incremental cost and its present or proposed price is, however, a reasonable and appropriate factor in determining rates for individual services.

IV. <u>Other Factors Affecting Rate Design/Rate Structure</u>

A. <u>Universal Service</u>

Universal service is one of the State's basic policies with regard to telecommunications service. RCW 80.36.300. All the parties agreed that the Commission should consider universal service when considering rate design -- but each had a slightly different perspective as to what universal service may mean and how to achieve it.

USWC forthrightly acknowledges that universal service is very important and should be accommodated by assigning revenue requirement, if that is a reasonable option and still let the Company earn its revenue requirement. It contends that its proposed $26 per month residential rate is affordable. It urges that the phased proposed increase would give time to study universal service issues. Finally, it urges that only a very small proportion of USWC customers have expressed opposition to the proposed increase.

Commission Staff disagrees with the Company's conclusion, stating that the Company's proposed increases are huge and that it is unreasonable to deny that there will be an effect on universal service. Public Counsel/AARP argue that USWC has agreed that universal service is the fundamental concept -- the number one public policy goal -- in telecommunications. They argue that at the proposed rates, 39,000 persons would leave the system and that USWC's "affordability" analysis is seriously flawed. AT&T argues that universal service is important, but shouldn't be the determining factor in setting rates. Subsidies should be targeted toward specific individuals who need them, and collected in a competitively neutral manner from all competitors. It notes that household penetration varies with toll rates, not local service rates. It urges that outmoded internal cross-subsidies needn't be perpetuated in the name of universal service, but cites cost study data that show the residential class to meet costs and provide a contribution.

DOD/FEA support universal service, but contend that the universal service objective doesn't require a subsidy to the entire residential class. It cites a Rutgers University study that found most marginal users were driven off the network by toll. DOD asks the Commission to take official notice of the federal Telecommunications Act of 1996.[48] It suggests the use of a Joint Board to develop equitable and nondiscriminatory measures.

DIS reaffirms the State's statutory Universal Service policy. WITA suggests that the Commission not use the USWC rate case to define universal service, noting that there are other forums in which this is being addressed. WITA supports the USWC offer in Ms. Owen's rebuttal, to provide for a lower rate if necessary, to those customers receiving assistance under WTAP (supported by a higher rate on others).

The Commission reiterates its concern and support for the concept of universal service. The Commission finds it unnecessary and inappropriate, however, to pursue universal service considerations in this proceeding. First, there will be no massive increase to threaten universal service. Second, the Commission has begun Docket No. UT-950724, an inquiry into universal service, to explore universal service in today's transitional regulatory environment and mechanisms by which it may be maintained. The Telecom Act at Sec. 254(a)(1) also requires that the FCC initiate rulemaking to define services that should be supported, the support mechanisms, and other changes.

The compression of residential rate groups into a single statewide rate will cause rate increases to some persons, especially persons in small, rural exchanges. Because the rates are so low, even modest increases will be a significant percentage rise and may be significant to low income individuals. Because of the low base, the modest dollar size of the increase, and the level of the resulting rates, however, the Commission is confident that its order will not adversely

---

[48] The Commission believes that the Act may be cited without taking official notice. Nearly all parties have cited the Act on brief.

affect universal service within the State.

B. Competition

USWC argues that it faces competition in the markets that currently provide contribution to support services priced below cost: toll, access, and business local exchange. USWC cites the ease of registration as a telephone company, access to public rights of way and USWC structures, free numbering, free interconnection, low-cost number portability, low-cost private lines, a filed unbundled loop tariff, and the passage of federal legislation mandating conditions to promote local service competition. USWC contends that competition has grown to the point that the Company is beginning to have trouble handling the traffic delivered by competitors to its network.[49]

Commission Staff points out that USWC enjoys a ubiquitous network funded by captive ratepayers. Staff contends that de facto barriers continue to exist for market entry. Staff acknowledges that competition is increasing, but contends that competitors now have a negligible market share. Staff urges that the Company can ask for competitive classification if it thinks services are competitive. Instead, says Staff, the Company argues that the existence of any competition requires it to act as though the market is fully competitive. Each of the current alternative technologies (wireless, cable, competitive land line) has its own technical and other limitations. There may be pervasive competition in the future, say Commission Staff -- but not now.

Public Counsel/AARP argue that even though there is open entry and some entrants, there is no evidence that effective competition exists in any, let alone most or all, of the markets that USWC serves. Public Counsel/AARP urge that evidence of revenue increases tends to refute USWC's claim that it is losing business to competitors. Some of the competitors USWC cites, say Public Counsel/AARP, have substantial technological or practical barriers to becoming full alternatives for the ubiquitous network. The analysis of competition should focus on price-constraining competition, not anecdotes or speculation. USWC provided no evidence demonstrating the existence of that sort of competition. We find that USWC continues to enjoy substantial advantages: a ubiquitous network on which it enjoys a unique monopoly position; access to every customer; high market shares; substantial market power; some entry barriers remain, such as lack of number portability; USWC can use "special contracts" for large users to compete with entrants; USWC has the 1+ dialing advantage; cellular is benefiting the Company by providing additional access revenues; cable has technical problems; there is no demonstration that competitive access providers (CAPs) are offering lower rates or having a substantial effect

---

[49] Nowhere in USWC's case does it address its competitors' (potential or actual) cost of providing service. USWC has not shown or attempted to show that any competitor can offer a particular service at rates below those currently charged by USWC. Instead, USWC's case for competitive threats to its profitability rests on (1) the absence of legal or regulatory barriers to competition and (2) anecdotes about plans of other firms to enter USWC' s markets.

upon market share. We find that personal communications service (PCS), specialized mobile radio (SMR) and satellite service are in early development stages and not a competitive threat; and interexchange carriers (IXCs) use incumbents' facilities because it is to their economic advantage to do so.

AT&T argues that from the record, competition in local exchange service doesn't yet exist and that USWC cries wolf. But, AT&T argues, emerging competition will be affected by the rates that are set in this proceeding. The DOD/FEA also acknowledge that the specter of competition is much closer now that the federal Telecom Act has been enacted, adding new urgency to USWC's requested rate restructuring. WITA contends that the transition from monopoly to competitive markets demonstrates USWC's need to restructure rates. WITA argues that competition is here and that value of service pricing must be abandoned in favor of cost-based pricing.

The Commission finds that effective or price-constraining competition does not exist. The Commission concludes that, to the extent USWC has predicated its rate spread proposals on competitive threats, those proposals should be rejected. USWC witnesses were not credible in assertions as to the existence or threat of competition, and were not supported with objective information that would permit a finding that effective competition exists. Rates will not be lowered, and costs will not be shifted to captive customers, based on anecdotal evidence. To do so would not result in rates that satisfy the statutory requirements to be just, fair, reasonable and sufficient.

The Commission also recognizes, however, that competition may develop in the markets served by USWC and that it is in the best interest of both the Company and its customers to prepare for greater competition. USWC, unfortunately, has not offered a reasonable approach to emerging competition. We encourage the Company to examine the markets for its various services and, where it appears that effective competition exists, seek to have those services declared competitive as provided for in RCW 80.36.330. Such a competitive classification would enable USWC to raise or lower rates for that service in response to market conditions. Where effective competition exists, market pressures can replace traditional rate regulation.

In addition to encouraging USWC to seek competitive classification where appropriate, we believe it also is in the public interest for USWC to have downward pricing flexibility for services that, while not yet subject to effective competition, are facing competition of some sort. This can be accomplished under Washington state law by using the banded rate provision in RCW 80.36.340.[50]

---

[50] The statute reads as follows:

80.36.340 Banded rates. The commission may approve a tariff which includes banded rates for any telecommunications service if such tariff is in the public interest. "Banded rate" means a rate which has a minimum and a maximum rate. The minimum rate in the rate band shall cover the cost of the service. Rates may be changed within the rate band upon such notice as the

USWC has sought to tie its competitive responses to its monopoly services. Its market response -- to lower rates for toll, access, and business services -- was linked to higher rates for monopoly services -- in particular, residential exchange service. In effect, USWC wanted to make residential ratepayers responsible for its success or failure to compete in other markets.

The more appropriate approach is to give USWC the tools it needs to respond to competition while still protecting captive customers from monopoly pricing. The banded rate statute is that tool. It will permit USWC to lower rates when doing so is necessary to respond to competition. If USWC determines that a particular rate established in this order is higher than the market will bear, it will have the flexibility to lower that rate and meet the market. The Commission finds that in current regulatory circumstances, the limited use of banded rates authorized in this Order is in the public interest.

This Order will therefore authorize USWC to file tariffs with banded rates for any service that it believes is likely to face competition. The upper limit for each rate should be the rate determined in this case. The lower limit should be no lower than the TSLRIC of that service, calculated in accordance with the decisions on cost studies in this order, or the price floor set through imputation where required. USWC will be allowed to change rates within the band on 10 days' notice to customers and the Commission, by analogy to the provisions of RCW 80.36.330. Within that period, the Commission may complain against the filing. If it does, the burden is on the Company to demonstrate both that the rate is above cost and that it is fair, just and reasonable. Especially important here, where we have found that the Company does not face effective, price-constraining competition in the markets for many services, proving that a price is fair, just, and reasonable involves a demonstration that it is not anticompetitive.

WAC 480-80-045 requires banded rate filings by telecommunications companies to include a statement of public interest, cost study results verifying that the minimum rate covers cost, and information on the revenue impact of the banded tariff. Because the Commission is authorizing banded rates on record evidence, including market conditions and cost studies, the Commission does not contemplate the generation of new data or studies, but authorizes USWC to refer to record evidence accepted by the Commission as valid, when the Company provides support for its proposed tariff revisions. We expect that the evidence of record will satisfy the requirements of the rule.[51]

---

commission may order.[1985 c 450 § 6.]

[51] The Commission considered banded rates for USWC in Cause No. U-86-40. There, it rejected USWC's request to set a band of $20 to $8 for remote call forwarding, which was then tariffed at $16. The Commission reiterates its conclusion in that proceeding that the upper band should be the revenue requirements level. The circumstances today are sufficiently different from those of years ago that the other guidelines set out in the order in U-86-40 should not apply here. However, the Commission is sensitive to the possibility of unintended consequences and

There may be concern that a set of banded rates, with the upper bounds set at the revenue requirements level, could only result in rates that are insufficient, since any downward price movement would cause revenues to fall below the revenue requirement determined in this case. The Commission believes that concern to be ill-founded. USWC can be expected to use the pricing flexibility of banded rates to maximize its revenues; it is unlikely to lower rates for a service unless competition forces it to do so. Where competition exists, a rate that meets the market will generate more revenue than an above-market rate.

By granting USWC downward pricing flexibility, we are not taking away the Company's ability to seek increases in its overall revenue level or to seek a revenue neutral rebalancing of rates. If USWC believes that a reduction in rates for one service needs to be offset by an increase in rates for another service, it can request that rebalancing. Banded rate authority simply gives USWC a tool to respond more quickly to competition without putting captive customers at risk. This gives USWC more ability to compete without sacrificing our legal obligation to protect captive customers from monopoly pricing. Alternative banded rates provide USWC with the greatest level of pricing flexibility allowed under Washington law without a showing that a service is subject to effective competition.

C. Imputation and Price Floors

Imputation tests must be performed to ensure that USWC does not put a "price squeeze" on competitors using its bottleneck monopoly services. For example, the access charges paid by interexchange carriers are imputed to USWC's retail toll charges, even though USWC does not pay those access charges, to ensure that its toll rates are not anti-competitive.

According to USWC, the test is simple:

> Does the price cover at least the incremental cost at the ASIC level plus imputed tariff rates for truly essential services required by competitors to provide the same or similar service? [USWC rate design brief, p. 42.]

USWC argues, however, that the only essential service is interconnection itself; everything else that could be purchased from USWC could also be self-provisioned. Thus, USWC concludes, imputation is a non-issue in this case and all USWC services pass any reasonable imputation test.

Beyond its assertion that imputation is a non-issue, USWC does not offer a point-by-point defense of the imputation calculations it placed in the record. In testimony USWC proposed several changes to existing implementation methods used by the Commission. These

---

reserves the right to reopen this proceeding for the purpose of examining the effect, the performance, and the continuing propriety of banded rates filed in accordance with this Order.

include (1) excluding the local transport rate, (2) excluding access charges imposed by independent local exchange companies (ILECs), (3) and making the calculation on the average toll rate instead of individual toll rate elements.

WITA agrees with USWC that ILEC access charges should not be imputed in USWC toll rates, arguing that the exclusion best balances the policy goals of a designated carrier with those favoring the beginnings of competition.

Commission Staff agrees with the Company that all toll offerings exceed the price floor, and argues that the Company-proposed changes to imputation test are flawed and unneeded. According to Staff, only billing and collection, that have been classified as competitive, may be imputed at its long range incremental cost (LRIC); all other elements must be imputed at tariff rates. Allowing imputation at average rates would stifle competition because the Company could freely devise high-volume plans that others couldn't match. Staff contends that its view is consistent with the Commission's second and third Supplemental Orders in U-88-2052-P and the fifth Supplemental Order in U-87-1083-T.

MCI and Sprint argue that USWC's requested changes in imputation are inappropriate. AT&T criticizes USWC's proposed changes to the imputation method, without disputing that USWC's proposed rates pass the imputation test. AT&T instead argues that imputation tests are not adequate to protect competitive markets from monopoly power. If USWC's toll is priced at the imputation floor, AT&T would earn zero profits while USWC was enjoying the very high markups on access charges, and the solution therefore is to price monopoly inputs to competitors at TSLRIC.

DOD/FEA note that imputation is still required, although its importance declines as services become competitive. They argue that the price floor of incremental cost is now a mandated requirement under the federal Telecommunications Act of 1996.

The Commission rejects the Company's proposal to include only the interconnection rate in imputation. The Commission finds that unless a bottleneck service is effectively competitive, if it is necessary to the competitor using it we cannot assume that a competitor will be able to circumvent it. It must then be imputed at the tariff rate. Unless the Commission finds a service to be competitive, the Company must include all bottleneck functions in its imputation at the tariff rate. Similarly, the Commission rejects other changes that the Company urges for imputation tests. Until services are truly competitive, the Company's services are essential in practice for some or all existing and prospective competitors. Abandoning the imputation standards now in place would allow the Company to price in a manner -- even though above its TSLRIC -- that would restrain the growth and development of competition.

D. Service Differences

USWC argues that the traditional differences between services such as toll, local exchange, EAS, and private lines are disappearing. In the future, competing carriers will offer all sorts of bundled and unbundled service option packages. The Commission should not be bound by traditional concepts of utility rate discrimination when deciding upon appropriate rate spread.

Public Counsel/AARP say that the differences between business and residential service are significant and that they justify the current difference in rates. Business service includes a yellow pages listing, involves more on-peak calling and more total calling, and gets faster repair service. The cost of business service is usually tax-deductible, while residential service usually is not. Public Counsel/AARP recommend equal percentage rate reductions for business and residential service, which results in a greater dollar reduction for business.

The Commission agrees that the distinctions among services may become blurred. As more persons engage in home occupations, as providers of alternative technologies and providers of other services enter the telecommunications marketplace, and as bundling of services occurs for marketing purposes, the traditional distinctions may well blur. The Commission finds that, as with price-constraining competition, that time has not yet come and it finds that distinctions among services still exist and define those services, and that tests relating to competition and pricing should be applied on the basis of services. This Order moves rates in the direction USWC urges, and future proceedings will allow the Commission to evaluate future costs, future market conditions, and other appropriate elements in rate setting.

In this Order, the Commission will maintain the residential local exchange rate at its existing statewide average rate. It will substantially reduce the revenue requirement for comparable business services, narrowing the proportional difference. It believes, however, that the factors Public Counsel/AARP mention -- yellow pages listing, calling patterns and volumes, faster repair service, and tax-deductibility, along with considerations of universal service and gradualism -- do support maintaining a substantially higher rate for business than for residential service. The Commission is sensitive to the needs of small business and believes that reductions in business class revenues, the collapse of rate groups, and the advent of competition will work to increase service options and maintain or lower total telecommunications costs. The Commission believes that equities and social policies continue to support the distinctions among services and the rate differentials we approve in this order.

V. Local Exchange Services

A. Residential

1. Flat

USWC proposes to increase residential rates in four annual phases, eliminate rate groups, blend EAS increments into the basic line rate, and introduce an "urban-rural" zone pricing structure. The statewide rate for a flat single party line in the final year would be $21.85 in Zone 1 and about 20% higher at $26.35 in Zone 2. USWC contends that residential rates must ultimately recover their fair share of costs or be supported by universal service funds. In its brief, USWC says that it must modestly deaverage its rates between urban and rural locations on a cost basis if it is to sustain its operations. It argues that residential rates are now below the national average in Washington State, that 30% of residential customers don't contribute to costs by making toll calls, and that nearly half of all customers don't contribute to costs by subscribing to ancillary services. The Company says the Commission should start by 1) setting a consolidated rate of $19.69, including an average $5.46 increase plus the revenues formerly provided by EAS, and 2) indicating its approval of the concept of zone pricing for future rate changes.

Commission Staff contends that the Company's costing methodology has been inconsistent with economic theory and prior orders. Staff contends that the Company has overstated the costs attributable to its basic residential service and that the existing rates are well above the monthly cost for that service (Ex. 602-T, 15-16; Ex. 605-C). If any cross subsidy exists, says Staff, it is contained within residential customers as a group -- not between residential and business customers. Staff supports the Company proposal that the current rate group/EAS additive structure be eliminated and replaced with a uniform statewide residential service rate. Staff, however, recommends a flat statewide rate of $10 per month per line, which exceeds the monthly cost identified in Exhibit 605-C.

Public Counsel/AARP also contend that rates now cover costs and that the Company's presentation does not support an increase. They urge that common line costs are shared costs and should be recovered from all telephone users. They urge a statewide rate of $8.43. TRACER cites Dr. Zepp (Ex. 788T and 789-C) and Mr. Spinks (Ex. 602-T and 604-C) to support its contention that residential rates are not subsidized. TRACER and DIS also support a single statewide rate, but take no position on what the rate level should be.

DOD/FEA contend that USWC cost studies for residential service were excessive but it does not endorse a rate reduction because much of the support mechanism for residential exchange service is subject to revocation under the terms of the federal Telecom Act or, for instance, in the case of Yellow Pages, is subject to erosion from increased competition. DOD/FEA contend that the Commission must be prepared for the unpleasant reality that monthly residential exchange rates probably must rise.

MCI believes the record does not require or support any significant increase in rates for residential subscriber, citing the Hatfield Model cost study as evidence that local loop and local exchange costs are covered. AT&T contends (Citing Ex. 485C and Mr. Mercer's rebuttal and supplemental exhibits, Ex. 761T through 767) that the record demonstrates that revenues attributable to local exchange service, including subscriber line and CCLC, cover their TSLRIC. AT&T urges that USWC therefore faces no revenue shortfall, and any adjustments to its local exchange service rates should be uniform.

All parties either support rolling EAS additives into the rate or make no comment.

It is clear from the record on cost study results that residential local exchange service already covers its incremental cost. There is no subsidy of this service by other services. The need to ensure that each service at least covers its own TSLRIC therefore provides no basis to increase residential rates. However, as noted above in our discussion of cost studies, it is not enough to determine that a rate exceeds TSLRIC. Residential customers share with other customers the responsibility for recovery of shared and common costs.

The appropriate level of contribution is a matter of judgment about how to weigh the public interest, equity among customer classes and groups, the public policy encouraging universal access at affordable rates, and the need to avoid sudden shifts in rates whenever possible. In this proceeding, an important factor is that no overall increase in rates is being ordered.

Having considered all of these factors, we find that the current average statewide single flat residential rate is the appropriate level for residential service in this proceeding. Residential service covers its own costs and provides a reasonable contribution to the overhead of the Company. That contribution is not so large as to justify a rate decrease. We also agree that it is appropriate to eliminate EAS additives and fold them into the average rate. The EAS charges have been established principally on the basis of lost toll revenue rather than cost. It is important to consider costs when setting rates and to use valid reasons for departing from cost.

We decline to reduce the residential class average rate. The restructuring we accomplish in this Order will allocate reductions to other classes and services based on our view of the long term public interest. We expect that it will reduce some of the pressures for future rate reductions for other classes or services, and thus benefit the residential class with more stable rates. Reductions in toll and access service will also benefit customers of those services in the residential class.

While there will be no change in the average rate for flat-rated residential local exchange service, the move to a statewide rate by eliminating the current rate group structure will result in rate increases for some customers. To mitigate against the effect of this increase, the Commission believes that the rate increase should be phased in over two years. Rates for customers whose current rate is more than a dollar below the statewide average rate should initially move halfway to the new rate, and the remaining increase should be implemented in one year. Rates for all customers above the statewide average rate should immediately move to the new rate.

2. Measured Service

USWC proposes to eliminate the existing variable cost-per-minute structure and replacing it with a 3¢ charge for each minute. Usage packages of three and six hours would be increased by 30¢ and 85¢, respectively, per month. The Company proposes converting the remaining customers who use a frozen service called basic measured service. The measured service rate would go to $9.25 initially and to $13.75 over four years. According to USWC, this would simplify the cost structure and bring the rates up to cover costs.

The Commission Staff agrees that the Company's cost studies show current usage rates to be high in relation to their costs. While the Company's proposal to charge a uniform 3¢ a minute simplifies the current structure, it also increases the already high usage charges by over 50% for a four-minute call. Staff recommends that the service be restructured to better reflect the service costs for the loop and usage. Staff recommends that the rate be reduced to 1.5¢ per minute for the first minute, and 1¢ for additional minutes. Staff recommends that the measured monthly recurring line rate be increased from the current $4.83 to $7.00. The net revenue impact of these two recommendations is $47,669. Finally, Commission Staff recommends that the existing measured service packages be grandfathered to avoid forcing 20,000 existing customers to migrate to higher priced alternatives. (Ex. 602-T, pp. 18-19; TR 3407-08.)

Public Counsel/AARP agree that measured service usage rates should reflect cost, proposing that the charge for the initial minute be 2.5¢, with subsequent minutes at 1¢, and with a 40 percent discount for off-peak usage. The monthly recurring rate would equal 70% of the single-line, flat, monthly residential service rate.

The Commission accepts the Public Counsel/AARP proposal. It most closely reflects the costs of the service and establishes an appropriate relationship between flat-rated and measured service. Existing budget service customers shall not be grandfathered, as Commission Staff proposes. The Commission shares Public Counsel/AARP concerns that the measured service rates cover incremental costs, and yet provide a viable option to persons who do not require flat rated service. Rate increases that result should be phased in as provided for above for flat-rated service, i.e., customers whose current rate is more than a dollar below the new rate should pay half the increase now and the remainder after one year.

B. Business

At present, the Company's rates distinguish between "simple" and "complex" business services, and vary by rate group, according to the size of the exchange. USWC proposes to restructure these relationships, eliminating the distinction between simple and complex lines; eliminating rate groups for a statewide rate, and in the second year of rates instituting a "Zone" structure in which a higher rate would apply to service in exchanges that the Company considers "rural." In addition to this restructure, it proposes several additional changes in charges for business services.

1. Simple/Complex Service

In present rates, simple service consists of four or fewer lines; complex services consists of five or more lines. Each line in Complex service is priced higher than each line in simple service. Exchanges are divided into four rate groups, with charges higher for service in exchanges having more customers.

USWC proposes to eliminate the distinction between simple and complex services. It would also eliminate rate groups, with flat-rate single party business lines priced at $29 statewide in the first year, up for most customers from the current statewide average of $25.85. USWC would discount additional lines by five percent. It argues that the proposed changes in rate structure are required to bring prices more in line with costs.

Commission Staff proposes that the Commission implement the restructure approved in Docket No. UT-930957. This would result in a single statewide rate for simple and complex lines, hotel, PAL,[52] and semipublic of $25.85. The Centrex NAR[53] and the DSS[54] rates would be $18.65.

Public Counsel do not oppose eliminating the simple/complex business line differential. TRACER supports a single statewide rate, with NAR and DSS trunk prices aligned with that rate. TRACER contends that USWC failed to justify a higher first-line charge.

DIS supports a statewide business line rate and agrees that current rates exceed costs. DIS agrees that the simple/complex distinction is a disincentive to expansion and proposes 1) pricing all business lines at one statewide rate, with the level dependent on the revenue requirement that the Commission finds; 2) aligning the NAR and DSS trunks with the statewide rate; and 3) rejecting zone pricing.

The Commission accepts the Company's proposal to eliminate the pricing distinction between simple and complex service. It is clear from the evidence that the costs of

---

[52] PAL stands for Public Access Line, a service provided to payphones.

[53] NAR stands for the Network Access Register, which provides access to the network and allows customers to aggregate multiple stations onto a single access port.

[54] DSS stands for Digital Switched Services and provides PBX access to T-1 facilities.

additional lines do not increase, so the simple/complex distinction is not cost-based. It is a disincentive to acquire additional lines and thus can impede business communication. This is most burdensome on small business, for which the additional lines may constitute a particularly significant proportion of expenses. Hotel and toll trunks and semipublic lines should be priced at the same rate as business lines.

The Commission rejects the discount for additional business lines. The revenue requirement that we find allows a rate that is lower than any party proposed for business service and minimizes the effect upon business. A demonstration in a future case of cost differentials for additional lines may persuade us that a discount is appropriate.

The Commission will set the business exchange rate at $25 per month. This rate provides both a reasonable contribution to the shared and common costs of the firm and a substantial rate reduction to business exchange customers. While most customers will experience a rate decrease as a result, the elimination of rate groups and the simple/complex distinction will cause rates for some customers to increase. To mitigate the short-term impact on these customers, the Commission will order a phase-in of the increase for all customers whose increase would be more than one dollar per month. Those customers should pay half the increase now and the remainder after one year.

2. Private Branch Exchange (PBX), Network Access Register (NAR), and Digital Switched Service (DSS)

USWC urges that establishing new rates for PBX, NAR and DSS is contingent upon an imputation test that includes rates established for local interconnection. Until then, the Company proposes to leave PBX trunk rates at the level of the current complex line rate. Although an interconnection filing is expected in July, 1996, no one knows when that case will be finally resolved. The Commission therefore sees no reason to delay adjusting PBX, NAR, and DSS rates consistent with other rate adjustments in this case. USWC can propose new rates for PBX trunks if it is appropriate, following resolution of the interconnection case and the filing of the appropriate imputation tests.

USWC contends that PBX trunks have unique cost characteristics. It argues that usage, and therefore usage costs, are generally higher for PBX lines than other business lines. The Company's evidence, however, shows that PBX trunk loop costs are generally lower than other business lines because the loops are typically shorter. (Ex. 505.)

Commission Staff argues that Company cost studies show a minimal difference in non-traffic sensitive costs between PBX trunks and simple business lines, and that usage cost differences do not appear to justify a separate PBX trunk service. Staff does not oppose a separate usage increment for PBX. Public Counsel proposed a separate $11 usage increment for PBX trunks to recognize the usage difference.

TRACER cites Mr. Farrow's exhibit (Ex. 341-C) to show that the $1.06 difference in usage costs (ASIC) is partly offset by differences in loop costs, lowering the net ASIC costs between a business line and a PBX trunk to $.65. TRACER argues that the only instance where a significant cost difference arises is between a business line and a PBX trunk that has DID, direct inward dialing. In those cases, the PBX customer pays an additional charge for the cost of DID terminations which more than makes up for the cost difference. DIS and TRACER oppose Staff's suggestion that a separate usage increment for PBX trunk customers would be permissible to recognize usage differences because there are no significant differences in costs between business and PBX trunks.

The Commission agrees. It finds that costs and usage of the services are similar, though not identical. Based on the evidence in this case, there is no justification for pricing PBX trunks differently from a business line. The rate for a PBX trunk shall be set at the same level as the statewide rate for a single business line, $25.00 per month. NAR and DSS rates shall be established by aligning the rates with the single business rate, reduced by the Network Access Channel (NAC) or NAC equivalent.

TRACER and DIS have shown and the Commission finds that NARs and DSS services require separate purchase of the equivalents of the NAC and the switch interface non-traffic sensitive central office equipment (NTS-COE). If the NAR and DSS prices were set at the business line price, the Centrex and DSS customer would be charged twice for NACs and connections to the USWC switch (780-T, 9). Staff, TRACER and DIS recommend that the NAR and DSS be aligned with the new business rate but adjusted so as to avoid double charging customers for the NAC.

The Commission accepts the Staff, Tracer, and DIS position for the reasons stated and sets the rate for NAR and DSS trunks at $14.00, by subtracting the NAC rate established in this order from the newly-established statewide business rate.

3. <u>Direct Inward Dialing (DID)</u>

USWC's proposal would increase DID trunk termination recurring rates from $33 to $40 per month and increase non-recurring charges by $10, based on USWC's asserted need to increase revenues.

Commission Staff states that these proposed increases are not cost justified. DOD/FEA argues that the rates are anticompetitive because DID rates are paid only by PBX users -- DID is provided as part of the feature package of Centrex Plus service. The effect is to broaden by $7 per trunk per month the price advantage of USWC's service relative to competing PBXs.

DIS and TRACER recommend that DID trunk terminations be reduced because of the service's importance for E-911 (allowing call back) and because the price is currently many times the service's TSLRIC. DIS and TRACER recommend the lowest practical price. In lieu of such a rate, DIS and TRACER endorse the $16.50 rate for one-way DID that is in place in Oregon. Public Counsel/AARP contend that USWC failed to demonstrate that this rate increase would affect similar-sized PBX and Centrex customers in the same way.

The Commission rejects the proposed increase. The Commission finds that there is no cost differential sufficient to support rate increases. There is no revenue deficiency to be met. The Commission has above ordered that PBX line rates be brought into alignment with business rates and it reduced the average business rate. Holding the existing rate provides for sufficient contribution to shared and common costs and will avoid enhancing the Centrex price advantage.

4. Hunting

Hunting is a feature offered by USWC to customers using two or more lines. If the number dialed is busy or fails to answer, hunting automatically directs the call to the second line, or beyond if that line is busy. USWC proposes to increase the recurring rates for Hunting from $2 to $4 per month, based on its perceived need to increase USWC revenues. The Company proposes to eliminate the charge for the last line of a Series Completion Service hunt group since the last line does not hunt for another line.

Commission Staff opposes the proposed increase because it is not cost justified, and does not oppose eliminating the charge for hunting the last line. DOD/FEA points out that line hunting is included in the Centrex Plus feature package and that multiline hunting is a virtual prerequisite for the effective use of a PBX. They contend that the Company's sole motivation for this proposal is to improve the competitive position of USWC's Centrex Plus offering. DIS, TRACER and Public Counsel/AARP urge rejection for the same reasons.

The Commission finds that the USWC charge for this service is an example of monopoly pricing. Not only does it increase the competitive advantage of the Company's Centrex services, and not only is it priced at many hundreds of times its cost, but it appears to impose additional costs upon USWC and the general ratepayer body. First, because hunting is an important convenience -- nearly a necessity -- it adds to the effective cost and to the current inverted rate structure for additional lines. From that standpoint the charge for hunting masks the real charge of such lines and by increasing that charge operates to restrict sales of other lines that could also bring contribution to the system. Second, to the extent that the service is rejected because of its rate, it impedes business and personal efficiencies: outside callers are inconvenienced by having to call back or try another number. Third, if hunting is not purchased, the multiline customer may miss calls from persons who choose not to call back or dial another number.

For the above reasons, the Commission directs that the hunting charge be reduced to 5¢, a figure appearing to be several times the cost of the service. This reduction, along with the reduction in average business rates, will operate to the benefit of small business customers. We expect that the reduction will stimulate sales of additional lines, adding contribution, although we do not reflect any additional lines in revenue calculations. We expect that inconvenience and missed calls will be reduced. All told, we believe that this will be a true win-win situation in which the customer benefits, the Company benefits, and the public benefits.

C. Zone Pricing of Local Exchange Service

The Company proposes to deaverage rates for local exchange services as a response to competition and to reflect its perception that costs of providing service in urban areas are lower. WITA endorses zone pricing. Part of the USWC territory, including all exchanges with EAS to metropolitan exchanges, would be declared urban. Remaining parts of its territory (including Olympia) would be deemed rural. Residential rates would be $21.35 in the urban zone in the fourth year of the Company's phase-in proposal, and "rural" rates would be 20% or $4.50 higher.

Commission Staff recommends rejecting zones because current average residential rates exceed the statewide average cost of residential service; business line rates far exceed the cost of service; and because it believes that competitive pressures have been overstated. In addition, the zones have anomalies in which some areas in the rural zone are more urban than some areas in the urban zone.

TRACER and Public Counsel/AARP argue that zone pricing has not been justified. Public Counsel/AARP opposes "loading additional charges on customers with even fewer options than those in urban areas." DOD/FEA support rate adjustments to reflect major differences in costs and believe the existing "value of service" rate group structure is out of step with the times.

It is clear from the record that the cost of providing service is not the same for every customer. The Hatfield model results adopted by the Commission show that the costs increase as the population density decreases. In other words, it does cost more to serve rural areas. Ex. 767. That factual conclusion does not , by itself, support a policy decision to adopt zone prices. The Commission finds that the existence of cost distinctions and the magnitude of distinctions depend on the particular service. Many factors led the Commission to reject zone pricing in favor of a single statewide rate. There is no demonstration that USWC's proposed zones correctly place exchanges in the proper zones. Indeed, USWC has included some very rural exchanges in its so-called "urban" zone. Even if USWC had proposed a cost-based division of exchanges, the two zones would have each contained exchanges that had different customer densities and therefore different costs.

The same logic that would support the zone concept would then call for dividing each zone into sub-zones, with the only logical stopping point being a unique rate for each customer, reflecting that customer's costs. That outcome is not one observed in competitive markets or in the other industries subject to our regulation. Absent some compelling reason, such a radical change in pricing structure must be rejected. A statewide average rate promotes affordable local telephone service, minimizes rate shock, and provides USWC the ability to provide service at rates that exceed the average cost of providing service.[55] The Commission is willing to reconsider this ruling if competition takes hold and if doing so is permissible.

D. Business - Residential Relationships

USWC contends that its proposal for the first year retains a 2:1 ratio of business rates to residential rates but suggests that in the future rates should be consolidated.

Staff supports the near term business to residential ratio of 2.5:1 implicit in Staff's recommendations. Public Counsel/AARP support the existing ratio. DOD/FEA challenges Public Counsel/AARP's argument that the ratio between business and residential rates remain the same. DOD/FEA contends that business line and PBX trunk rates should be lower than residence line rates. TRACER says the Commission should give no weight to ratios and base their decisions instead on underlying costs and public policy considerations.

The Commission has no target ratio in mind when it establishes rates. It finds that each service is covering costs, although the business rates are higher above incremental costs. A simple ratio does not reflect other relevant factors in pricing, such as tax advantages, directory advertising advantages, repair advantages, etc., that the Commission may consider in pricing. With those reservations in mind, we note that the ratio of existing service is approximately 3:1 and the ratio we propose is approximately 2.5:1 We note that the existing ratio does not reflect the charge for hunting, which many customers may feel to be essential, and which we order substantially reduced. Nor does the ratio reflect charges for message toll service, which is also reduced.

E. Revenue Impact

The restructuring of residential flat-rated service to eliminate rate groups and EAS adders, and to establish a single statewide rate at the current average, has no revenue effect. The revenue effect of approved changes to the measured rate structure is $385,000. The revenue effect of establishing a business rate of $25 with no simple/complex distinction and no rate groups is a revenue reduction of approximately $31,800,000 including the effects of stimulation.

---

[55] While we base our rejection of zone pricing on the policy considerations outlined above, it is worth noting that the federal Telecom Act appears to prohibit rate differentials that impose substantially higher rates on rural than urban areas.

VI. Toll and Access

A. Toll Services

USWC's message toll rate proposal would compress mileage bands and decrease rates by $18.6 million in the first phase and decreases mileage band rates by another $17.4 million in the second phase. There would be no differential between the initial and subsequent minutes. Optional calling plans would be restructured and rates reduced, 800 Service Line hourly rates would be decreased, and TollPac discounts would be reduced from 30 percent to 15 percent by the second phase. The total reduction of these proposals is $22.8 million in Phase 1 and $19.8 million in Phase 2. USWC contends this is a competitive response similar to one that would be made by any party faced with a "dwindling market share." USWC contends that its toll call volumes have been shrinking at 3-5% per year while competitors' volumes are growing at 5-16% (Ex.55), and it proposes the rate reductions to allow it to maintain market share.

MCI opposes the new toll plans unless USWC satisfies the Commission's imputation standard. Specifically, it urges that USWC toll rates should not be reduced prior to lowering access charges to its competitors. AT&T argues that with USWC access rates many times the Company's direct cost calculations, the Commission should reduce the rates for access before approving any rate reduction for intraLATA toll. DOD/FEA believe that there are compelling reasons for toll reductions and observes that even if the proposal is approved, USWC intrastate toll will still be higher than interstate toll.

1. Message Toll Service (MTS)

USWC proposes to decrease toll rates by $18.6 million in the first phase, and decreases mileage band rates by another $17.4 million in the second phase. It proposes to eliminate the differential between the initial and subsequent minutes.

Staff supports the proposal to restructure and reduce rates for basic message toll service. It observes that costs are becoming less distance-sensitive, and a number of other toll service providers have adopted equalized minute rate structures. With the exception of some computational flaws and reservations about the Company's assumed price elasticity value, the Staff's witness, Mr. Selwyn, found the Company's calculations and methodology acceptable.

Staff contends that USWC's elasticity value is a one-year estimate and does not reflect the full anticipated demand response associated with the toll rate reduction. Using Staff's long-term estimate provides an additional $8.3 million in net annual revenues to the Company. (Ex. 380-T, p. 71; Ex. 382, p.9).

Public Counsel/AARP support only modest toll reductions, and then only if a revenue surplus between $50 million and a $100 million is found. They contend that the Company has failed to demonstrate a genuine competitive threat to toll. Public Counsel/AARP opposes having the same charge for the initial minute as for subsequent minutes because it exacerbates the existing disparity where residential MTS carries a higher margin than business MTS.

AT&T argues that the USWC proposal fails to afford true rate relief to consumers and that it is anticompetitive because it compels residential ratepayers to finance a toll reduction that increases the price squeeze on USWC's competitors, while ensuring that the Company maintains its revenue stream. Toll rates should be reduced, argues AT&T, but only as a byproduct of reductions in switched access rates that allow competitive forces to work.

The Commission agrees that the Company's concerns regarding toll competitors have some merit. In this Order we authorize USWC greater flexibility to adjust its prices to meet competition in a nondiscriminatory manner through banded rates. As markets become competitive, it is essential that the Company have the flexibility to transition into the role of a market competitor. It has had little practice as a competitor and banded rates are one mechanism permitted under regulation that will allow flexibility to meet competition within an identified range. In calculating its rates to meet its revenue requirement, the Company shall use and be prepared to demonstrate long run stimulation effects of lower rates.

The Company's proposal to reduce toll rates is reasonable and should be approved. We find Staff's estimate of the revenue effect to be the most accurate and we adopt it. We approve eliminating the premium for the first minute of toll, as it will result in rates that reflect the rate structures of toll competitors and that are easier to quote and easier to understand. We reject AT&T's request that toll reductions be contingent upon one-plus dialing for competitors' intraLATA toll; A rulemaking on one-plus dialing will soon move forward and we see no reason to deprive the Company of needed competitive ability and operating flexibility in the interim. The proposed phase-in of toll decreases was related to phased increases in local exchange rates. Because we have rejected those increases, the toll decrease should be implemented in one step.

2. Optional Calling Plans (OCP)

USWC's proposal for optional calling plans is to remove nonrecurring charges (NRCs) for the Plans, merge business plans into one and lower its rate; lower the rate for the volume plan; and add a 5% discount to business hour discount plan. USWC's revenue impact prediction differs from its calculation of revenue decreases from lower rates. USWC contends that the NRCs should not be eliminated.

Commission Staff says the Company's proposals for optional calling plans suffer from the same failure to use long-term estimates of elasticity as the Company's MTS proposal. Public Counsel/AARP and Staff believe that the Company should recover non-recurring costs, even if minimal, from the users of the OCP offerings, and Public Counsel/AARP agree that the Company's stimulation projections are inaccurate. WITA supports the development of a variety of toll discount plans and believes they should be available in independent LEC territory on the same terms and conditions as in USWC territory.

The Commission finds that the Company's proposed changes are supported by the record and accepts them, with slight modifications. First, the Company shall consider long-term stimulation effects in calculating revenue. To the extent that short-term effects are used and such rates continue in effect, the Company's income would be understated. Second, we accept the Commission Staff and Public Counsel/AARP proposal to require some non-recurring charge because of the costs of administration. Adding a charge will discourage customers from hopping back and forth on and off the plan and will recover the administrative costs from the cost-causers. We reject AT&T's arguments that the proposal is anticompetitive, because no costs are being spread to captive customers, because access charges are also being reduced, and because a number of competitors are becoming active in the toll market

3. Toll Pac

USWC proposes reducing the Toll Pac discount for MTS service from the current 30 percent to a proposed 15 percent, and freezing the service, contending that it no longer achieves its purpose and that it is out of line with other services USWC offers in other states.

Public Counsel/AARP claims Toll Pac relieves some community pressure for extended area service and provides one of the few residential toll discounts available. WITA supports the Public Counsel/AARP analysis.

The result of this order will be a significant toll decrease, reducing the need for a Toll Pac discount package. EAS has been granted to many areas, also reducing need. The discount is not cost-related. For these reasons, the Commission accepts the Company proposal.

4. Revenue Impact

Staff's corrections of the Company's calculations and use of long run elasticity demand result in the total revenue impact of the toll reductions of $32,268,662 (Ex. 382, p. 10).

B. Switched Access

USWC provides switched access service to interexchange carriers (IXCs), also known as long distance companies, who use USWC's network to connect their customers' calls. Without that access, each carrier would have to build its own local exchange lines to provide long distance service to its customers.

It is not a matter of dispute that access charges greatly exceed the incremental cost of access.[56] According to the record, USWC's current switched access rates greatly exceed its own direct cost calculations (Ex. 485C; TR 3209-10). Access charges are significant beyond their direct contribution to USWC revenues because they are an element in other companies' charges.

Proposals made by parties range from no reduction in access charges (Public Counsel/AARP) to a revenue reduction of almost $47 million (AT&T).[57] USWC proposed a reduction of about $15.3 million. Commission Staff presented evidence that USWC's proposed rates would reduce revenues by $12 million, rather than $15.3 million. Staff supported a set of access charge reductions that would produce a $12.0 million reduction in revenues.

The Commission has concluded that a substantial reduction in access charges is reasonable. The appropriate reduction should exceed the amounts proposed by Staff and USWC. Because access charges currently are above cost, the magnitude of reductions are primarily a function of the overall revenue requirement in this proceeding and the other rate design changes that must be made. We believe it is appropriate to require an overall reduction of approximately $29 million, consisting of $22 million in access charges paid by IXCs and $7 million in access charges paid by independent local exchange companies, with an additional $5.3 million reduction phased in over the next two years.[58] The Commission also believes that extensive changes in the structure of access charges are in order. These changes include adoption of the local transport

---

[56] The incremental cost of access does not include any costs of the local loop or non traffic-sensitive central office equipment. Those facilities are shared by local and toll services and are properly included as a shared cost rather than an incremental cost of either service. If loop costs were included in the incremental cost of switched access (i.e., if IXCs were required to pay the full cost of the facilities necessary to reach their customers), switched access rates would fall far short of covering cost.

[57] DOD/FEA contend that the 1996 Telecom Act is relevant. They argue that, because the Telecom Act forbids setting interconnection elements with reference to a rate of return proceeding, any access rates approved in this proceeding are unlawful, null, void, and violate several provisions of Act. The Commission disagrees. We recognize that this proceeding is transitional and that the rates we set may be interim. The rates are a part of the Company's overall revenue requirement established in a pending proceeding. The Telecom Act has not invalidated any existing rates. The Commission is not beginning a new proceeding aimed at access rates. It is not delaying or impeding any federally prescribed process for access rates. The Commission does not challenge the primacy of the Telecom Act and intends to operate in compliance with it. The rates authorized herein will be in effect only until superseded by rates established pursuant to future lawful process. We believe that the actions taken herein are consistent with the Telecom Act. See, Telecom Act, Sec. 251(b)(3).

[58] The access revenue decreases should offset and coincide with the revenue increases resulting from phased in increases in basic exchange service and terminal loops authorized elsewhere in this order.

restructure, setting transport rates equal to comparable dedicated access rates, rejecting the proposed residual interconnection charge (RIC), and eliminating the carrier common line charge (CCLC).

Several factors lead to the decision to make such a substantial reduction in access charges. First, the markup over incremental cost is substantially greater for switched access than for other major services that use the local loop, namely toll and local exchange service. Second, access service is purchased by USWC's competitors in the toll market. The Staff and USWC proposals would have reduced USWC's retail toll rates by more, on an average cents-per-minute basis, than its wholesale access rates, and therefore deserve more scrutiny. Third, the reduction in access rates can be expected to have substantial economic benefit for residential and business customers of this state.[59] Toll calls are a substantial portion of the total telephone bill of many customers, and this reduction will make their overall telephone service more affordable. The resulting rates will still make a contribution to all shared costs, including costs of the local loop.

1. <u>Local Transport Restructure (LTR)</u>

In Docket No. UT-941464, the Commission accepted the general structure of the company's proposed LTR, but rejected rates and included guidelines for revisiting the subject in this case. USWC proposes to reduce local transport rates by $15 million and to impose zone differentials. No party has opposed LTR. Areas of disagreement instead center on the specific rates and rate elements, particularly the Carrier Common Line Charge and the Residual Interconnection Charge.

The Commission accepts the basic restructure developed in UT-941464. Specifically, USWC should file rates for dedicated trunked transport based on the rates for comparable service in its dedicated access tariffs, for tandem switched transport as it proposed, and for local switching. The LTR proposal also included continuation of the CCLC and creation of a new RIC. Those rate elements should <u>not</u> be included in the access service rate structure, as discussed below. The overall level of revenues from access services should initially be approximately $47.9 million, including revenue from IXCs and independent LECs.

2. <u>Carrier Common Line Charge (CCLC)</u>

The CCLC was created 10 years ago as a mechanism designed to avoid the "rapid

---

59 Some parties have expressed concern that the interexchange carriers will not pass through the access charge reductions by lowering their in-state long distance rates. This is a legitimate concern, though we believe competition among carriers will cause the reduction to be passed through. With a reduction of this magnitude, the effect on retail rates should be easily measured. Parties represented on the record that pass-through could be expected, and the Commission will consider the speed and the extent of pass through any future proceedings in which further access charge reductions are proposed, including the two phased-in reductions ordered here.

and total deloading of NTS (non-traffic sensitive) costs onto the entire class of end users in the state." (U-85-23 et al., 18th Supp. Order, p. 8). There has not been, until this case, a comprehensive review of USWC rates and revenue requirement. This case provides the opportunity to examine and question the value of rate elements, particularly those elements that work against an efficient and straightforward rate design. The process of determining the CCLC, by USWC admission, involves "an elaborate and involved set of allocations" (Ms. Wilcox, TR 3232, line 24).

AT&T argued that the CCLC is intended to contribute to the costs of the local loop, but the record establishes that the revenues attributed to local service cover the incremental cost of the services. USWC countered that the Commission's previous orders have recognized that carriers receive benefit from using USWC's network and should contribute to the common overheads incurred in maintaining that network. Staff and Public Counsel/AARP also support the continuance of the CCLC for the same reasons.

The Commission's accepts AT&T's argument that the CCLC is best eliminated. The CCLC has outlived its function and it is time to retire it as a specific rate element of switched access. By eliminating the CCLC, the Commission is not excusing toll carriers from responsibility for supporting the shared and common costs of the network it uses to reach its customers. On the contrary, the revenues assigned to switched transport and switching still include a significant contribution to shared and common costs. However, there is no longer a reason to treat one shared cost -- the local loop and NTS-COE -- differently from the many other shared and common costs of the firm. It is reasonable and appropriate for access charges to contribute to the recovery of shared costs -- including the local loop -- but the assignment of costs using the CCLC is no longer warranted.

To allow the CCLC to continue to exist is to imply, inaccurately, that local exchange services require a "subsidy" from toll. Eliminating the CCLC does not put USWC at risk in terms of recovering its costs; the question is not how much revenue to collect from switched access service but rather what rate elements should be used to collect that revenue. Eliminating the CCLC takes an important step away from the historical method of assigning costs, and the result will be a more streamlined rate structure where rate elements have a direct bearing on the service provided.

3. Residual Interconnection Charge (RIC)

USWC proposes a Residual Interconnection Charge, or RIC, to be applied to switched access. USWC contends that it is a balancing tool with which it proposes to generate contribution. USWC argues that it is needed for local exchange carriers to remain viable. AT&T argues that there is no justification for introducing another rate element on a service that's already more than covering its costs, and urges that it is one element of a transparent attempt to increase rates for switching, which only USWC can provide, while reducing it for transport, which is becoming competitive. MCI and Sprint oppose the RIC; Commission Staff accepts the concept but suggests that the charge apply only to traffic transported through USWC local transport facilities[60] and Public Counsel expresses concern about some details, but does not oppose it.

Having already made the decision to eliminate the CCLC, an old method of recovering shared costs, the decision to avoid establishing a new one is simple. The Residual Interconnection Charge is not related to any one service but is rather a proposed balancing tool for a Local Transport Restructure that was originally proposed outside of a rate case. MCI contends that a RIC is unnecessary in a rate case since there is no obvious need to keep LTR revenue neutral. The Commission agrees. Transport rates and switching rates will be set to produce the level of revenues that the Commission determines to be reasonable and sufficient. The practical result of the RIC would be to increase the switching rate. It is much more straightforward simply to set the switching rate at the appropriate level.

4. Local Switching

USWC proposes to increase its charge for local switching to 0.9¢ per minute in its "urban" zone, up from 0.65¢ per minute proposed in UT-941464, and 1¢ per minute in its "rural" zone. Staff, AT&T, MCI, Sprint, and DOD/FEA all oppose the increase.[61] The real switching rate that USWC proposed also includes the CCLC and the RIC, increasing the rate to over 4¢ per minute.

The Commission concludes that a reasonable switching rate will result from combining the switching charge and the CCLC amounts proposed by Commission Staff. In other words, taking Staff's proposed switching rate as the starting point, the CCLC at its current level should then be rolled into the switching rate and the RIC should be rejected entirely. This produces a rate of slightly over 2¢ per minute, which is reasonable, and revenues of about $34.5 million. The exact rate and revenue amount, however, should be determined by calculating the difference between the overall revenue requirement in this case and the sum of all other rate changes approved in this order. Further access charge reductions should be made in one year and two years, to coincide in time and amount with the revenue increases that result from the phased-in increases in term loop rates. Each of these reductions will equal about $2.5 million. Thus, the ultimate level of switching revenues ordered here is about $29.5 million.

The Commission believes a switching rate of slightly over 2¢ per minute is reasonable. This rate will result in revenues equal to about $34.5 million, which is the amount that would be produced by the switching charge and CCLC proposed by Staff. In other words,

---

60 The proposal does not appear sound, as it would be burdensome to administer and it would handicap the Company's ability to compete in transport.

61 The positions of various parties must be considered in the context of their positions on the appropriate levels for the RIC and CCLC. Commission Staff, for instance, proposes a switching charge of 0.65¢ per minute, but it also would levy a RIC of 0.695¢ and a CCLC that averages about 1.8¢ per minute. The total charge, therefore, for traffic switched by USWC would be more than 3¢ per minute.

taking Staff's proposed switching rate as the starting point, the CCLC at its current level should then be rolled into the switching rate and the RIC should be rejected entirely. The exact rate and revenue amount, however, should be determined by calculating the difference between the overall revenue requirement in this case and the sum of all other rate changes approved in this order.

This significant decrease in access costs can be expected to stimulate demand for access services, and this effect must be anticipated and accounted for in determining the specific switching rate. USWC proposed no elasticity or "stimulation" adjustment, arguing that it could not be sure that interexchange carriers would pass the reduction through in retail rates. USWC apparently does not disagree with the idea that if retail rates are reduced, its access demand and revenues will increase. Its position against an elasticity adjustment would require one to accept the idea that interexchange carriers will pocket the entire reduction in access costs. In fact, while the reduction in retail rates could be greater or less than the access charge reduction, the most reasonable conclusion in a competitive market is that the full reduction will be reflected in retail rates. An appropriate long-run elasticity value should be used, based on the effect of reduced access charges on the retail rate for toll services. (Ex. 380-TC, p. 70). The elasticity adjustment should be calculated on that basis.

5. Transport

In deferring the local transport restructure from the interconnection case to this case, the Commission had hoped for a more thorough discussion from USWC regarding how to align rates among transport services. Instead, USWC acknowledges in its brief that it has proposed the same levels of transport charges that the Commission rejected in the Interconnection order. That order said that the ratio between DS1 and DS3 should be no lower than the ratio of their TSLRICs. USWC contends that their proposed rates is equal to the lowest ratio of USWC's Seattle-area competitors whose rates have ratios below that of their TSLRICs, providing proof that a ratio below TSLRIC but no lower than USWC filed rates will not hurt small interexchange carriers. Ex. 556-C.

The Company did not attempt to verify whether small interexchange carriers were, in fact, purchasing service from these competitive access providers. Thus, the Commission cannot find whether such rates are proof that a similar ratio for USWC rates will not cause harm or be anticompetitive. On the contrary, there is extensive evidence in this record and noted in the Interconnection order demonstrating the discriminatory potential of transport rates that do not reflect a proper ratio between DS0, DS1 and DS3. See, the Interconnection order at page 81.

Commission Staff contends that the Company needs to comply with the interconnection order regarding pricing of transport by pricing transport services so that they maintain a ratio between their rates that is at least equivalent to the ratio of their respective TSLRICs. In the absence of any further evidence or argument elucidating this matter, the Commission reaffirms its prior decision.

AT&T cites revised USWC data on historical demand that shows USWC revenues for transport would increase 30% over what the Company originally estimated (compare Ex. 553, p. 3 with Ex. 563. p. 3). AT&T argues that the rates styled "illustrative" by USWC in Ex. 565 should be adopted.

Sprint expressed concern that customers of tandem switching should not be required to cover overheads above that which is paid by customers using direct trunked transport. The Commission agrees that local transport restructure should treat equally efficient competitors neutrally, regardless of their size.

Elsewhere in this Order the Commission directs USWC to set its private line rates so that DS-1 and DS-3 mileage rates reflect the ratio of their underlying incremental costs. The Commission also is rejecting USWC's proposal to decrease voice-grade private line mileage rates. USWC's proposed rates for tandem switched transport, entrance facilities, and multiplexers appear reasonable and are not opposed by other parties. The Commission believes that, with that restructure, the rates for dedicated access service provide a reasonable basis for dedicated trunked transport access service.[62]

6. Equal Access Charge

USWC proposes to eliminate its equal access charge and to recover the revenue in the RIC. AT&T argues that the equal access charge is not cost-based, has been eliminated from USWC's interstate tariff, and would be recovered from access charges in about one week of growth in revenues at the annual average rate of 10%. The Commission so finds, and concludes that there is no longer a need for an equal access charge.

---

[62] Commission determined in the interconnection case that rates for dedicated access service and the dedicated transport component of switched access service did not have to be priced equally. Fourth Supplemental Order, UT-941464. Given the similarity in these services, however, it is desirable to price them on the same basis if conditions permit, and in this instance they do.

7. Zones

The Company proposes to establish zone pricing for the Carrier Common Line Charge, the RIC, and local switching in addition to local exchange service. It argues that the proposal reflects costs, but that cost differences are not essential to pricing differences, and competitive conditions have been recognized historically as appropriate factors in regulatory pricing.

Commission Staff and MCI contend that USWC did not show a cost difference between its urban and rural zones, but merely made a general assertion that costs of serving average customers are lower in urban areas. Staff argued that with switches being priced on a linear basis, there is no reason to believe that a cost basis exists to deaverage switching rates or the contribution elements of access. USWC did not attempt to make an argument that zone pricing was cost based but rather in response to competition. To sustain such an argument, USWC would need to show that its competitors can underprice its switching service in particular areas, and it has provided no evidence on that point.

The Commission rejects zone pricing for switched access charges, for the reasons stated in rejecting other applications of the Company's zone proposal. Neither cost differences nor competition differences justify this rate structure.

8. Revenue Impact

The rate structure approved by the Commission will result in an initial reduction of $22.0 million in switched access charges paid by IXCs and a reduction of $7.3 million in switched access charges paid by independent LECs. The total ultimate revenue effect, including the reductions that will coincide with terminal loops phase-in, is a reduction of about $39.3 million.

VII. Dedicated Services

A & B. Private Line/Terminal Loops, Analog/Digital

USWC proposes extensive revisions to its analog and digital private line service rates. The analog network access channel (NAC) rate would increase, channel performance and mileage rates would decrease, terminal loops and remote control office services would be grandfathered and eventually discontinued, non-recurring charges would be increased, and digital private line service would be restructured.

These proposals, along with changes proposed by Staff and TRACER, must be considered in context of USWC's overall dedicated service offering, as well as similar services that are provided under USWC's switched access and basic exchange tariffs. We will discuss each element of these proposed changes separately.

1. Network Access Channel (NAC)

NAC rates are currently at $9.00 for a two-wire circuit and $18.00 for a four-wire circuit. USWC proposes increases of $2 and $4, respectively. Staff and TRACER had proposed decreases of the same amounts as a way to offset the increase in revenues as term loop service is merged with private line service.

At the rates proposed by Staff and TRACER, the NAC service would be priced below the incremental cost of an unbundled loop, which is about $8.96 (Ex. 765-T, p. 4). Overall, the level of contribution from analog private line services falls short of that from digital private line services. On this basis, rather than USWC's asserted need for additional revenues, the increases proposed by USWC should be approved.

2. Channel Performance and Mileage Charges

Rates for channel performance features should be reduced as proposed by TRACER. USWC has failed to provide adequate estimates of the cost of channel performance on a least-cost basis, but it appears that these services are priced sufficiently in excess of cost that the price reduction proposed by TRACER for these elements is warranted.

Both TRACER and USWC proposed lower mileage charges. TRACER would reduce mileage charges to match those for E-911 service. That service does not provide an appropriate basis for private line transport rates. USWC proposed a smaller reduction, but the contribution from these mileage rates already is lower than the contribution from DS-1 and DS-3 mileage charges. No change in these mileage charges is warranted.

3. Terminal Loops

The Commission's decision in the Terminal Loops case to bring term loop rates into line with private line rates should be implemented in this case. No party objected to this alignment. This will align rates for similar services and correct the problem that term loop service currently is priced below its cost. Rates for term loops customers will more than double as a result of this change. USWC proposed to phase in the increase. Rates would move immediately about one-third of the way toward private line rates, and the remaining gap would be closed in 1997 and 1998. This phase-in is appropriate to provide a needed transition time for term loops customers.

4. Digital Private Line Service

The Commission accepts USWC's proposal to combine Digicom I and Digicom II into one service. This change will provide a higher level of service for current Digicom I customers and reduce rates for Digicom II customers. NAC and channel performance elements will be bundled into a single channel termination service. USWC may provide discounts for customers who sign long-term contracts, as is already done for higher-speed digital services.

However, the rate increases that USWC proposed for channel termination at lower speeds are rejected. As Commission Staff points out, the proposed increases were based on USWC's asserted need for an overall revenue increase. The services already are priced above cost and those prices should not be increased. The current Digicom I rates should apply to the new Digital Data Service.

5. Non-recurring Charges

The restructure of private line non-recurring charges should be implemented as proposed by USWC. Some current charges are below cost, and this restructure will eliminate that problem. This restructure is the second step of the revision to non-recurring charges begun last year. Both Commission Staff and TRACER support USWC's proposal.

C. DS-1/DS-3

Many parties argued DS1 and DS3 issues in the Switched Access Transport section, above. As discussed in that section, USWC never revised its DS-1/DS-3 pricing ratio to conform to the Commission's guideline to adopt, at a minimum, a TSLRIC-based ratio. USWC rates should at a minimum reflect this ratio. Currently, the markup over TSLRIC is lower for DS-3 service than for DS-1 service. Staff proposed increasing the DS-3 mileage charges to achieve the proper relationship to DS-1 charges. TRACER would correct the price disparity by lowering the DS-1 charge.

Achieving this relationship requires either an increase in the DS-3 rate, as Staff proposed, or a decrease in the DS-1 rate, or a combination of the two. TRACER makes a persuasive argument, especially in light of the revenue requirement of this case and the overall high levels of contribution from high-capacity private line services, that the better approach is to lower the DS-1 rate. Mileage rates for DS-1 transport should be lowered as proposed by TRACER.

D. Revenue Impact

The revenue effect of these changes depends on the price elasticity for private line services. Commission Staff and TRACER expressed concern that the Company failed to assess repression properly. To estimate repression from the term loops increase, USWC used data from restructuring terminal loops in Oregon, and it argues that this is the only study available in the proceeding. USWC argues that this study measures the long-term impact of the rate increase.[63]

DIS and TRACER challenge the repression analysis because it reflects data over several years, different from the price elasticity estimates that the Company uses with other services. Data in the Term Loops case, they contend, indicate that the number of term loops sold in Oregon changed for many reasons, not only price. Finally, they contend that the repression analysis does not recognize offsetting revenues that USWC can expect to receive as term loop customers switch from one USWC service to another. Thus, they argue, the Commission should assume no repression if it must increase net revenues from private line and terminal loop service.

The Commission agrees that USWC's repression estimate for the term loops increase is unreasonably high. The Company's proffered term loops repression value is theoretically and empirically unsound. The Commission notes that, while USWC was using an unreasonably high elasticity value to estimate term loops repression, it assumed no elasticity effect from the rate decreases it proposed for digital private line service. Assuming zero price elasticity is equally unsound. While both assumptions are unsound, each works to USWC's advantage by understating its revenues.

The Commission is concerned that assuming no price elasticity would be both inaccurate and unfair to USWC, since it would produce a higher revenue estimate than it is reasonably likely to obtain. TRACER witness, Dr. Zepp, used an elasticity value of -.25 in calculating the revenue effect of his proposed change in DS-1 rates.[64] That estimate is the most reasonable and accurate available estimate of price elasticity for private line services and should be used for all stimulation and repression estimates relating to the private line rate changes discussed in this section.

---

[63] We note that USWC supports a short-run elasticity factor in calculating the stimulation in demand from the reduction in toll rates. The combination of a long-run value for rate increases and a short-run value for rate decreases is both inconsistent and works to USWC's advantage by understating its revenue levels. A long-run value should be used in both situations, though the particular value may be different for different services.

[64] Dr. Zepp did not calculate elasticity effects for his proposed changes in analog private line rates. His overall proposal was revenue neutral, and the elasticity effects would have been approximately offsetting.

The revenue effects, with elasticity effects as discussed above, are as follows:

Increase analog private line NAC rates; reduce channel performance rates	\$0.8 million
Align term loops rates with analog private line rates	\$7.5 million
Merge digital data services at Digicom I rates	(\$0.5 million)
Restructure non-recurring charges	\$0.8 million
Reduce DS-1 mileage rates	(\$1.5 million)
Total revenue effect	\$7.2 million

VIII. Other Issues

A. Pay Phones

The Northwest Pay Phone Association (NWPPA) participated in this proceeding, addressing issues related to the Company's provisioning of customers' and its own pay phone services.

NWPPA's principal issue is whether the difference between USWC's retail pay phone rate of 25¢ and the rate it charges independent pay phone providers for an access line creates a price squeeze. USWC has produced updated imputation analysis that it contends will show that USWC's proposed Public Access Line or PAL rate (equal to the proposed business rate) passes the imputation test established by the Commission. USWC says its analysis is conservative because the actual compensation costs by USWC was 7 percent less than that budgeted in the cost study. No party other than the Northwest Payphone Association challenged this imputation test.

The NWPPA argues that USWC has submitted multiple conflicting imputation studies and has tried to change the imputation method approved by the Commission in UT-920174, which was decided on reconsideration last summer and is now on appeal by USWC. NWPPA's cost studies show that the coin phone rate would have to be more than 30¢ to avoid a price squeeze at the proposed PAL rate.[65] The NWPPA argues that the Commission should set

---

[65] The main points of contention in the cost studies appear to be (1) call volumes and (2) costs of the new "smart" Millennium sets. USWC uses higher call volumes based on very recent data. NWPPA argues that the recent data are not representative and that USWC has not reflected higher costs that would be incurred at these higher call volumes. The Millennium set costs

the PAL rate at USWC's TSLRIC. USWC contends that Sec. 276 of the Telecom Act preempts Commission action.

The Commission rejects the NWPPA challenge. The average PAL rate is lower as a result of this order than it was as a result of the earlier imputation docket, which found no price squeeze at the then-current business line rate. Thus, for a price squeeze to exist now, it would have to be the case that USWC's costs have increased. There is no good evidence to support such a finding. USWC is installing more expensive and more sophisticated terminal equipment, but not because "smart sets" are needed to provide local pay phone service. The additional cost of these sets can be justified only because of the toll revenues or savings in toll-related expenses that they will produce and their cost is not shown to be relevant to the imputation test for local pay phone service. We reject USWC's assertion that all pay phone issues are immediately preempted by the Telecom Act and find that we have jurisdiction to make this ruling, at least prior to the FCC's adoption of relevant rules. Telecom Act, Sec. 276(a).

B. Resale

The Commission said in the Interconnection case order[66] that any general prohibition on resale of services should be eliminated and that eliminating resale restrictions should occur in the general rate case. The federal Telecommunications Act now also prohibits local telephone companies from restricting the resale of their services.

AT&T argues that USWC enjoys cost savings when it sells high volumes of services and that to prohibit resale would stifle competition. It urges that resale prohibitions should be excised from every USWC tariff on file with the Commission. AT&T also argues that the tariffs should provide for specific resale rates below the retail level. The discount should reflect "TSLRIC cost savings as a result of wholesale service provision." AT&T cites Section 252(d)(3) of the federal Telecommunications Act as requiring a wholesale rate no greater than the retail rate minus costs attributable to any marketing, billing, collection, and other costs that would be avoided by the local exchange carrier.

AT&T argues that the appropriate discount is 33%. This figure is based on embedded cost data, because AT&T says it did not have access to incremental cost data for USWC. The Tennessee Commission adopted a 25% discount.

Commission Staff concurs in the need to permit resale of services, with the exceptions that residential service should not be resold to business customers and that local call termination may not be used to deliver toll traffic. It urges the Commission to require resale at wholesale tariffs reflecting the avoided costs of the incumbent's retail operations. Staff does not address the question of what discount, if any, should apply.

---

include capability to handle credit cards, and USWC says the revenue from use of that feature should be deducted from the cost of the set in order to compare local revenues with local costs.

[66] UT-941464, Sixth Supplemental Order, p. 19.

USWC notes the federal requirement for resale and argues that the Commission should rebalance rates "so that resale is not a financial disaster for USWC." USWC does not address the question of what discount, if any, should apply.

The Commission has in this Order granted many of USWC's requests regarding restructure. It believes that properly priced resale will not be financially harmful to USWC, as USWC fears, as it will be priced above cost and therefore result in contribution.

MCI argued that the discount from retail should be sufficient to permit a feasible margin for entrants. The Commission disagrees. Our concerns are that the sale is above the Company's TSLRIC and that it is net of avoided costs. There can be no guarantee that the result is a financially feasible, stand-alone resale opportunity for entrants.

The Commission finds it somewhat troublesome that the issue of resale was not more adequately developed on the record of this proceeding, although it understands the massive effort expended by all parties. It is clear that the record is insufficient to set a standard discount rate. It is also clear that federal law as well as the Commission requires that resale be permitted. The Commission will order the following.

When it refiles tariffs under the terms of this order, the Company must refile all of its now-restricted tariffs without any resale restriction. Doing so will comply with the Commission's order and the federal statute. Concurrently, it shall file a general resale tariff stating that resale shall be otherwise permitted at the tariff rate, less the Company's avoided costs for the service to be resold, upon a service-specific tariff to be filed upon the request of a potential reseller. The resale tariff may provide for reasonable financial security and shall provide that services may not be resold out of class.

While not entirely satisfactory, this approach will allow resale discussions to begin immediately and will permit the filing of specific tariffs for specific services. As time goes by, it may be feasible to designate an appropriate general resale discount or to develop specific cost studies for individual services to be resold.

IX. Other Services

A. Directory Assistance (DA)

USWC proposes an allotment of one free call allowance for each local exchange customer, and to increase the price of each subsequent call from $.25 to $.60. This brings the price well above costs, the Company says, and will not affect the more than 60% of all customers who never use directory assistance. USWC notes that competitors charge amounts higher than the rates USWC proposes. The Company argues that this increase is justified because the cost study reflects issues raised by the Commission, and there is a major new DA competitor.

Public Counsel/AARP, Commission Staff, TRACER and DIS recommend a two-call allowance, with additional calls charged at $.35 per call. Staff points to the Fourth Supplemental Order in the Term Loops matter, Docket No. UT-930957, in which the Commission authorized that rate but the Company refused it for reasons of revenue neutrality.

Commission Staff contends there are flaws in the Company's cost study and that USWC also cited a new competitor when it previously sought a DA increase. TRACER & DIS also recommend adopting the terms and conditions found reasonable in the Term Loops case, as well as using the Staff's updated estimate of the revenue impact, including contract revenues, which total $7.78 million.

The Commission rejects the Company proposal. We find that there is no evidence of cost or market change since the time of the prior order and believe its selection continues to have validity. The Company will be directed to reduce the no-charge call allowance to two calls and to increase the per-call charge to 35¢. The Commission also adopts the terms and conditions associated with the authority granted in the Term Loops order and it accepts the Commission Staff updated revenue estimates as most accurate.

B. Late Payment Charge (LPC)

USWC proposes a 1.2% charge on monthly past due balances above $45. The projected revenue impact is $4.7 million. Commission Staff opposes the proposal. It professes no inherent opposition to late charges, noting that other utilities use them, but contending that it opposes the charge because there are specific problems with the proposal.

USWC responds that Commission Staff's opposition is based on mere technical arguments and fails to explain why a late payment charge is not acceptable for USWC even though the Commission has approved one for Puget Power, and USWC's competitors apply late payment charges. WITA supports the proposal, calling it good business practice and consistent with the Commission's actions in applying a late payment charge to regulatory fees.

Commission Staff's "technical" arguments include the absence of cost justification and the possibility that applying a late charge on the lump sum of the bill will violate Commission rules. Staff proposes rejection until the Company complies with Staff's recommendations, including basing the charge on costs incurred by the Company; limiting the charge to regulated services; applying the charge only to local service billed in advance, applied 60 days after initial bill date; and providing procedures for medical emergency exceptions and for customers to establish a preferred payment date. (Ex. 797-T, 17-18).

Public Counsel/AARP support the late payment charge in concept, but oppose details of this proposal. They contend that the LPC should be adopted only if USWC applies the LPC to the Company's services only; the interest rate equals the Company's authorized return, and revenues are adjusted for the impact on working capital.

The Commission finds that the Company's is correct that a late payment charge is a reasonable way to recover costs imposed upon the Company and other ratepayers by persons whose payments are not timely. It rejects this proposal, however, it finds credible the concerns raised by parties, particularly Commission Staff. The Company may refile at a later time if it considers Commission Staff suggestions. The Puget Power late charge provision should be considered as a starting point. Charges may not be applied to fees billed for third parties unless the Company can demonstrate costs incurred thereby. The rate of the charge may be comparable to that allowed Puget Power. The charge may not be applied to bills for local service until the local service portion is past due for the required period. The Company should also allow customers to establish a preferred billing date during the month.

There is no revenue requirement requiring an immediate refiling of this proposal. The Commission will not require or authorize its refiling as a compliance item in this proceeding, but the Company may file for such a change at a later date.

C. Operator Surcharges

USWC proposes changes that provide consistency between rates for toll and local operator surcharges and which have an annual revenue effect of approximately $1.8 million. Public Counsel/AARP oppose these rate increases because they condone oligopoly pricing and discriminate in favor of USWC's "best deal" customers. (Ex. 420-T, pp. 144-45)

The Commission rejects the Company proposal. There is no revenue need for the proposal, and it is not shown to be cost-based. The service appears to provide a reasonable level of contribution based on current rates. There appears to be no need for the increase, and there is no indication of any reason why interstate rates should be appropriate for intrastate services.

D. Listing Services

1 & 2. Residential and Business

USWC proposes to increase its monthly charges for nonlisted and nonpublished numbers[67] by 25¢ per month and to increase the non-recurring charge for each by $1. It also proposes to increase the Joint User Fee for business directory listings on resold Centrex lines. The Company responds that its current rates for these services are among the lowest in its region.

---

[67] Nonpublished numbers do not appear in the directory but are available through directory assistance. Nonlisted numbers are not in the directory and are not available through directory assistance.

The revenue effect is $6.5 million, net of repression.

DIS opposes this rate increase for it moves rates away from costs. Metronet argues that the Company's proposal to increase the Joint User Fee is unsupported by any evidence; is priced considerably above cost; and is discriminatory. Metronet argues for a lower rate set at LRIC or LRIC plus 10 to 20 percent.

Public Counsel/AARP take issue with the proposed increases for non-listed and non-published numbers because they do not respect the legitimate privacy interests of customers.

The Commission rejects these requests. There is no cost justification for the proposals, and there is no unmet revenue requirement that would support a more general increase in rates and charges. We are also sensitive to the need of many persons for privacy for their own personal safety and to the possibility that the need may occur at all income levels.

E. Custom Calling

USWC proposes an increase in custom calling services, contending that it is appropriate because these services are perceived by customers as value added, discretionary services. Higher rates have been approved in other jurisdictions, says USWC, and this increase will enable USWC to provide its multi-state customers standard rates.

Commission Staff urges rejection of the increases because they have not been justified by any cost evidence. Public Counsel/AARP notes that these services are above cost at present rates but suggests that increases can be allowed if needed to meet revenue requirement.

The Commission rejects the proposal because there is no cost justification and because there is no revenue requirement that need be filled.

F. Centrex

USWC proposes offsetting any NAC rate increase with a decrease in the Centrex feature package price. Commission Staff's arguments are presented above in conjunction with our discussion of proposed changes to PBX, NACs and Centrex NARs.

Metronet contends that the Company proposal fails to meet the terms or the goals of the Centrex Plus order, that contemplate movement toward unbundling and nondiscriminatory treatment. It urges that no cost support has been produced for the discriminatory treatment. Pricing elements separately but requiring joint purchase is not unbundling. Metronet contends that USWC's actions violate the public service laws (RCW 80.36.150(5)); federal law, and the Centrex Plus order. The only excuse for such behavior, it argues, is to prevent arbitrage and protect services from competition.

Metronet reminds the Commission that it recognized the role of resellers and rebillers in the Centrex Plus case and that the Commission has identified the need to unbundle the NAC from the pricing of the feature package. It urges that this case offers the Commission the opportunity to enforce the parts of the order with which USWC is not now complying. In particular, Metronet contends, USWC should eliminate the location pricing structure that discriminates against resellers and it should unbundle elements of the Centrex Plus service. The result of location pricing and bundling is that USWC charges Metronet up to two and one-half times as much as it charges other similarly situated single customers. Metronet contends that, if the Commission accepts USWC's and staff's recommendations to lower business line rates before fully implementing the goals of the Centrex Plus Order, USWC competitors will likely be eliminated before a viable wholesale product exists for them. Under those proposals, Metronet contends that it would not break even charging the proposed rate until it had about 200 lines in a single central office. Metronet recommends revising the Centrex rate table to provide volume discounts based on the total number of NACs in the customer's system, regardless of location, and to revise the tariff to eliminate the requirement that the customer purchase a feature package for each NAC.

Enhanced Telemanagement, Inc. (ETI) argues that there is no need to relitigate the formula for aligning Centrex rates with private line NACs, NARs and PBX trunks. This formula is consistent with the Telecommunications Act's mandate to incumbents to offer resale of services. ETI contends that USWC's attempt to freeze Centrex service demonstrates that Centrex service is not competitive. It urges the Commission to reject USWC pricing proposals that would upset the existing Centrex Plus case formula.

TRACER and DIS believe the Commission should adhere to past orders where it found that the highest priced Centrex Plus station line should be set at the price of a private line NAC. The Commission should reduce the station lines to $7 (the private line NAC price proposed by DIS) and adjust the price of other Centrex Plus station lines accordingly. (Ex. 790-T, 7) The best available revenue impact estimate is a decrease of $11,405 supplied by Commission Staff.(Ex. 608)

The Commission finds that the existing arrangements are discriminatory and in practice they operate to benefit the Company. The Commission accepts Metronet's argument that it is high time for the Commission to order the Company to take the steps it encouraged the Company to take in the Centrex Plus compliance filing order.[68] The order and its predecessor[69] were clear in their terms and in their import. The Commission accepted a filing that fell short of perfection but enjoyed substantial agreement among most parties -- excluding Metronet -- and because it was a step in the direction ordered by the Commission. Now in this filing the Company has proposed measures that would regress from the imperfect arrangements now in

68 Sixth Supplemental Order, Docket Nos. UT-911488, 911490 and 920252 (Dec. 1994)

69 Fourth Supplemental Order, Docket Nos. UT-911488, 911490 and 920252 (Nov. 1993).

effect.

The Company shall file tariffs effecting the unbundling of the Centrex elements, pricing the highest Centrex Plus station line at the private line NAC rate, and remove the station location requirement. Doing so is consistent not only with both of the Centrex Plus orders cited above but also with the federal requirement requiring resale and unbundling.

G. Unbundled Loop

USWC contends that this issue need not be addressed in light of the Interconnection order and upcoming FCC rules mandating unbundled service. Commission Staff notes that the interconnection order deals with the issues, but urges adoption of the Commission Staff cost study recommendation in Mr. Lundquist's testimony (Ex. 385-T, pp. 22-30).

AT&T urges that the Commission forestall needless wrangling by resolving the cost and pricing issues now, with unbundled loops provided to competitors at USWC's TSLRIC of $8.96. MCI contends that the Company's proposals are not sufficiently unbundled, and supports the availability of the link and port components of the local loop at rates based on TSLRIC.

The Commission will require the Company to refile an unbundled Centrex service tariff consistent with the discussion above. The Company may not require the purchase of one separately priced item as a condition to purchasing another.

As to non-Centrex matters, the Commission has suspended the effective date of the unbundled loop service tariff filed by USWC. This filing was purported to be in compliance with the Commission's Sixth Supplemental Order in the Docket No. UT-941464 et al. The Commission needs time to analyze the comments and USWC's response before deciding whether to accept or reject the tariff filings. Unbundled loops will be dealt with in that proceeding.

X. Ordered Rates/Rate Spread/Summary Table

The table below summarizes the rates and revenue effects of the rate spread decisions set out above. The revenue amounts in this table reflect the full effect of rate changes that are phased in over more than one year.

Summary Table
Commission Decisions on Rate Spread

Service	Rate	Revenue Effect
Residential exchange		
Flat-rated (1FR)	$10.50/month	none
Measured (1MR)	$7.35/month	385,000
Business exchange		
1FB, PAL, semi-pub, hotel	$25/month	(31,831,000)
DSS, Centrex NARs	$14/month	(4,596,000)
Hunting charge	$.05/month	(3,780,000)
Local exchange usage	2.5¢ 1st min., 1¢ add.	minimal
Toll services		
Message toll service		(26,913,000)
Optional calling plans		(5,355,000)
Switched access		(34,372,000)
Dedicated/private line services	$11/month NAC	7,169,000
Directory assistance	2 free, $.35 addnl.	7,782,000
Total		(91,511,000)

Based on the entire record and the file in this proceeding, the Commission makes the following findings of fact and conclusions of law.

FINDINGS OF FACT

Having discussed above in detail both the oral and the documentary evidence received in this proceeding concerning all material matters, and having stated the Commission's findings and conclusions upon contested issues and the Commission's reasons and bases therefor, the Commission now makes and enters the following summary of those facts. Those portions of the preceding detailed findings pertaining to the ultimate findings stated below are incorporated into the ultimate findings by reference.

1. The Washington Utilities and Transportation Commission is an agency of the State of Washington vested by statute with the authority to regulate the rates, rules, regulations, practices, accounts, securities, and transfers of public service companies including telecommunications companies.

2. US WEST Communications, Inc. (USWC or Company) is engaged in the business of furnishing telecommunication service to the public within the State of Washington.

3. On February 17, 1995, USWC filed with the Commission, under Advice No. 2617-T, revisions to its currently effective Tariffs WN U-30, -31,-32, with a stated effective date of March 21, 1995. The intended effect of the tariff revisions is an annual increase in the Company's revenue of approximately $95,301,836 for 1995 and additional annual increases of $22,602,847 for 1996; $46,785,542 for 1997; and $39,923,697 for 1998; the total annual revenue increase requested, phased in over a four year period, is approximately $204,613,922. The filing was assigned Docket No. UT-950200.

4. By order entered March 8, 1995, the Commission suspended the tariff filing in Docket No. UT-950200, instituted a Commission Staff investigation, and ordered that hearings be held on the reasonableness of the revisions.

5. USWC's customer service performance has deteriorated significantly since 1991. USWC at times has insufficient facilities available to serve customer requests for service. USWC is reducing its annual capital investment in Washington State. USWC has restructured its operations, reduced the number of customer service centers, and reduced the number of staff persons available to install and repair the company's telephone service. Many callers for repair service have spoken with Company staff in distant cities who were unable to resolve their problems or dispatch repair service effectively. Follow-up customer calls were routed to distant cities, often different from the location answering the initial trouble report, and Company personnel were unable to find records of the initial report. USWC is failing to meet installation commitments because of insufficient staffing, the retirement or other loss of staff, lack of knowledge of the extent and location of existing facilities, and internal communication

performance. The "customer care package" that USWC voluntarily proposed offers some benefit to customers unable to receive service. With the modifications described in the body of this Order, it will offer an effective alternative to customers seeking but not able to receive service and will properly balance their interests and the public interest with the interests of the Company.

7. Team bonus awards and merit payments are tied to standards putting a primary emphasis on the Company's financial performance to the point where total failure to achieve customer service goals may be totally offset by superior Company financial performance. Such standards fail to tie bonus payments clearly and directly to customer service goals and permit emphasis on financial performance to the exclusion of customer service. Allowing the Company to petition for adjustment via a modification of this Order, and to secure the difference as found in this order upon a showing that the standards for payment of the awards meet Commission requirements and a showing of substantially improved, stable customer service performance, will provide incentive to the Company to improve its customer service performance.

8. Setting the Company's authorized rate of return on equity at the low end of the reasonable range and allowing the Company to petition for adjustment via a modification of this Order, and to secure the difference as found in this order upon a showing of substantially improved, stable customer service performance, will provide incentive to the Company to improve its customer service performance.

9. USWC voluntarily stipulated as a condition of the merger of its predecessor, Pacific Northwest Bell Telephone Company (PNB), with two other companies into USWC, that the merger would have no effect upon the imputation of yellow page earnings. U S WEST Direct, a division of Marketing Resources Group (USWD), benefits substantially from its existing relationship with USWC and from the former integrated operation as a part of PNB. Yellow page classified advertising directory publication constitutes a former regulatory asset of the Company. Neither PNB nor USWC received compensation for transfer of directory publication to another entity and USWC receives no licensing fee for directory publication although it receives a small fee for basic subscriber information at the same rate it charges all directory companies for the information. USWD's relevant yellow page advertising excess revenues during the test year were imputed at $50,934,378 to USWC's net operating income.

10. The test period beginning November 1, 1993, and ending October 31, 1994, is an appropriate period to examine for the Company's results of operation and should be adopted as the test year

11. Adjustments to test year revenues, expenses, and rate base pursuant to findings and reasoning in the body of this Order will portray the Company's test year results of operation and rate base properly for regulatory purposes.

12. Test year net operating income after all adjustments is $204,749,579. The

proper net-to-gross conversion factor is 1.565458 to derive the revenue needed to produce a given level of net operating income.

13. USWC's adjusted Washington intrastate rate base is $1,561,793,482.

14. The appropriate capital structure for USWC's Washington operation is 38.9% long term debt, 9.1% short term debt, and 52.0% equity. USWC's adjusted cost of long term debt is 7.57% and its cost of short term debt is 6.0%.

15. A rate of return in the range of 9.367% to 9.887% on USWC's rate base will maintain its credit and financial integrity and will enable it to acquire sufficient new capital at reasonable terms to meet its service requirements. Setting the authorized return at 9.367% with the opportunity to increase the authorization to 9.627% upon satisfactory resolution of customer service quality problems will provide incentive to USWC to improve its customer service quality. The appropriate overall rate of return for USWC is therefore 9.367%.

16. A surplus of $91.5 million exists in USWC's adjusted test-year revenues under the Company's presently-effective rates, based upon the findings of revenue, net operating income, conversion factor, rate base, capital structure, and rate of return found appropriate herein.

17. The rates and charges for telecommunications service in USWC's existing tariff produce revenues and net operating income that exceed reasonable compensation for providing telecommunications service in the State of Washington and are not fair, just, or reasonable. Revisions of rates and charges made in accordance with the findings and instructions in this Order will yield a fair rate of return on USWC's rate base found proper herein, and if filed pursuant to the authorization herein will be fair, just, reasonable, and sufficient.

18. Costs of providing service are properly shown in a study of total service long run incremental costs (TSLRIC). The Company's cost studies do not appropriately measure the Company's incremental costs of providing service. Costs of the local loop are not properly included in the incremental cost of local exchange service. To achieve sufficient results for regulatory purposes, cost studies should use the latest previously approved depreciation rates; the latest approved rate of return; actual rather than objective fill factors; and actual required per-line wire pair requirements.

19. The Hatfield Model cost study identifies the Company's true costs of providing local exchange service more closely than the Company's study, and is sufficient for purposes of pricing local exchange service. USWC's cost study contains information that, when selected and adjusted as specified in this Order, is sufficient to provide a guide to the Company's costs for pricing purposes.

20. The Company did not demonstrate that it faces effective competition sufficient to constrain prices in any market for its regulated services. The Company did demonstrate that it may face such competition and that it requires additional flexibility to meet competition. That flexibility may be achieved by authorizing the filing of banded tariffs to comply with the terms of this order, provided sufficient protections are established to protect prospective competitors and the public interest.

21. For banded rate tariffs to offer effective protection to the public and to prospective competitors, they must be filed in compliance with the terms of this Order; must identify a band whose ceiling is the rate specified in this Order and whose floor is no lower than the Company's TSLRIC cost of providing the service; must be subject to the Commission's continuing jurisdiction for study, review, evaluation and, in an appropriate reopening of this proceeding, such modification or termination as the Commission believes appropriate upon review of pertinent evidence; must show the initial rate as the rate established pursuant to this Order. To protect the public interest, any rate changes in a banded tariff must be made on no less than 10 days' notice to affected customers and the Commission and are subject to Commission complaint during that period, consistent with the terms of RCW 80.36.330. If the Commission complains against a rate change, the burden is on the Company to demonstrate that the rate is above its TSLRIC cost of providing service, and that it is fair, just, and reasonable, including that it is not anticompetitive.

22. The Company's public access line rate at the level directed in this Order does not impose a price squeeze upon independent pay phone providers.

23. The Company is required by federal law to provide its services for resale. The Company may comply with that requirement by refiling in compliance with this Order any tariff that now contains a resale restriction, without that restriction. The Company shall file a discrete general resale tariff providing 1) that it will file tariffs for sale for resale for specific services upon request; 2) that the wholesale rate shall be the existing retail tariff rate, less authorized avoided costs, and 3) that service may not be resold out of class. The tariff may provide for reasonable financial protections for the Company.

24. Centrex service tariffs that effect unbundling of the Centrex elements, price the highest-priced Centrex line at the level of the private line NAC, and remove the station location requirement will achieve the unbundling goals identified in prior Commission orders and will be fair, just, and reasonable.

CONCLUSIONS OF LAW

1. The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of this proceeding and all parties to this proceeding.

2. The test year adjusted results of operation and rate base herein found to be appropriate should be adopted for regulatory purposes.

3. The tariff revisions filed by USWC in this proceeding should be rejected in their entirety. USWC should be directed to refile revisions that will effect a reduction in annual revenues of $91,511,013 consistent with instructions in the body of this Order.

4. USWC should be directed to improve customer service quality. The Commission should order USWC to modify its customer care package as described in the body of this Order, and to require USWC to offer it until modification or termination is approved by the Commission. USWC should be ordered to initiate new customer reporting measures as specified in the body of this Order within 30 days of the date of this order. USWC should be authorized to earn at the low end of the appropriate rate of return on equity. USWC may petition in this Docket to have the rate of return restored to mid-range and to authorize the team and merit award adjustment upon USWC's satisfactory demonstration that its service quality has improved, as specified in the body of this Order.

5. The Company's cost studies should be rejected. The Hatfield Model cost study should be approved for use in this proceeding. USWC cost study information, selected and adjusted as provided in the body of this Order, provide information that is sufficient for use in setting rates in this Order.

6. USWC does not face effective competition that is sufficiently strong to constrain prices. Competitors are beginning to enter the markets for US WEST services. The Company needs the flexibility to transition to the role of market competitor. USWC should be authorized to file banded rate tariffs to comply with the terms of this Order, consistent with the requirements and restrictions set out in law and in the terms of this Order.

7. The Company should be authorized to file banded rate tariffs in compliance with this Order, consistent with instructions in the body of this Order, subject to the conditions that the initial rate shall be the rate ordered in this Order; that the Commission retains the authority to revisit the banded rate provision of this order, and that rate changes shall be filed on ten days' notice, during which time the Commission may complain against the rate change. In such a complaint the burden will be on USWC to demonstrate that the tariff rate exceeds the Company's TSLRIC and that the price is fair, just, and reasonable, including a demonstration that it does not act in an anticompetitive manner.

8. The Company should be required to file tariff revisions removing prohibitions on resale of its services, and to file a discrete general resale tariff providing that it will resell services, consistent with the instructions in the body of this Order.

9. The Company should be required to file revisions to its Centrex services

tariff or tariffs that effect unbundling as described in this Order.

10. All motions made during the course of this proceeding that are consistent with the findings, conclusions, and Order herein should be granted; those that are inconsistent should be denied.

Based on the foregoing findings, reasoning, conclusions, ultimate findings, and conclusions of law, the Commission makes and enters the following Order:

ORDER

The Commission hereby orders:

1. The tariff revisions filed by US WEST Communications, Inc. on February 17, 1995 in this proceeding are rejected in their entirety.

2. USWC's cost study is rejected. The Hatfield Model cost study is accepted for purposes of evaluating the costs of local exchange service. USWC's cost study elements as modified and limited in the body of this order are accepted for purposes of this proceeding for evaluating the costs of other services.

3. USWC is directed to improve customer service quality. USWC shall within 30 days begin making monthly service order reports which, at a minimum, shall include the following information by exchange by class of service: the number of all orders for primary exchange access lines received in a given month; the total number of orders held beyond five business days, identifying the number not requiring special equipment or service and the number requesting a later in-service date; and the cumulative reporting of all held orders until service is installed and in working condition. The reports shall be in a form agreed by the Company and Commission Staff and approved by letter from the Secretary. USWC is directed to offer its customer care package, with modifications required herein, to customers who are unable to receive qualifying service, until the Commission authorizes modification or termination of the program.

4. USWC is authorized rates in this proceeding based on the low point on the range of reasonable rate of return. The Company is authorized to petition in this Docket to have its rate of return restored to mid-range and to authorize the team and merit award adjustment upon USWC's satisfactory demonstration that its service quality has significantly improved, as specified in the body of this Order.

5. USWC's cost studies are rejected. The Hatfield Model cost study is adopted for purposes of local exchange service, and information within USWC's study, selected and modified as provided in the body of this Order, is accepted for other services for the purposes of this Order.

6. USWC is directed to refile tariff revisions consistent with the terms of this order, as set forth in this order, no later than 5:00 p.m. on Friday, April 19, 1996. The tariffs shall bear an effective date of May 1, 1996. The filings shall reflect no retroactive rate treatment and shall be strictly limited to matters required or authorized in this Order. The filings shall bear the notation, "By authorization of Order of the Washington Utilities and Transportation Commission, Docket No. UT-950200.

7. The refiling shall include revisions to any tariffs now providing restrictions against resale, to remove those restrictions. USWC shall file a resale tariff indicating that it will provide service for resale pursuant to specific tariffs to be filed; that it will file tariffs for resale within 30 days after a request to provide service is presented to it, unless an extension of time is approved by the Commission; and that service may not be resold out of class. The resale tariff may require reasonable assurance of financial and tariff compliance. Individual resale tariffs shall not be inconsistent with any existing resale arrangements or with the terms of this order contemplating resale.

8. USWC is authorized to file banded-rate tariffs consistent with this Order. The ceiling of such tariffs shall be the rates authorized herein. The floor of such tariffs shall be the Company's TSLRIC or its tariff rate for necessary services, whichever is higher. The initial filed rate shall be the rate established in this Order.

9. USWC is directed to file tariff provisions removing prohibitions on the resale of its services, and to file a general resale tariff, as found proper in this Order.

10. USWC is directed to file revisions to its Centrex tariff or tariffs that effect unbundling, as specified in the body of this Order.

11. Material in support of the manner in which the tariffs are constructed and in which the revenues herein authorized for USWC's telephone operations is obtained shall be submitted simultaneously with the filing to which it relates. Each filing shall be accompanied by a brief description of what the Company has accomplished by the filing and how it complies with the terms of this order, e.g., "This revision removes resale restrictions formerly in paragraph 2(e)" and by a legislative style version identifying changes.

12. A notice of the filings authorized in this Order shall be posted at each business s office of USWC in Washington, on or before the date of the filing with the Commission. The notice shall state when the filing is to become effective and advise that the filing is available for inspection at each such office. The notice shall remain posted until the

Commission has acted upon the filings.

13. All motions consistent with this Order are granted. Those inconsistent with this Order are denied.

14. The Commission retains jurisdiction over all matters and the parties in this proceeding to effectuate the provisions of this Order.

NOTICE TO PARTIES:

This is a final order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-09-810, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-09-820(1).

DOCKET NO. 20298-U

IN RE: ATMOS ENERGY CORPORATION'S 2005 RATE CASE

ORDER ON RECONSIDERATION AND FINAL ORDER

APPEARANCES

FOR ATMOS ENERGY CORPORATION:

Julius M. Hulsey, Attorney
Misty S. Kelly, Attorney

FOR THE COMMISSION ADVERSARY STAFF:

Philip J. Smith, Attorney

FOR THE CONSUMERS' UTILITY COUNSEL:

Clare McGuire, Attorney

TABLE OF CONTENTS

JURISDICTION

O.C.G.A. § 46-2-20(a) provides that the Commission has general supervisory authority over gas companies.

O.C.G.A. § 46-2-25 provides in pertinent part that whenever any new rate schedule is filed, the Commission shall have the authority, upon reasonable notice to the utility, to enter a hearing concerning the lawfulness of such rate, charge, classification, or service.

O.C.G.A. § 46-2-26.4 provides for the accounting treatments to be used in any proceeding before the commission to determine the rates to be charged by a gas utility. Subsection (b) provides as follows:

> In any proceeding commenced after April 1, 2002, to determine the rates to be charged by a gas utility, the gas utility shall file jurisdictionally allocated cost of service data on the basis of a test period, and the commission shall utilize a test period, consisting of actual data for the most recent 12 month period for which data are available, fully adjusted separately to reflect estimated operations during the 12 months following the proposed effective date of the rates. After the initial filing, and until new rates go into effect, the utility shall file actual cost of service data as they become available for each month following the actual data which were filed. The utility shall have the burden of explaining and supporting the reasonableness of all estimates and adjustments contained in its cost of service data.

STATEMENT OF PROCEEDINGS

On March 18, 2005, the Atmos Energy Corporation ("Atmos" or "Company") filed a notice with the Georgia Public Service Commission ("'Commission") stating its intention of filing an application for a general rate increase of rates and charges for service to customers in Georgia on or about May 1, 2005. In recognition of the Company's notice, the Commission, on April 11, 2005, entered a Procedural and Scheduling Order setting the schedule for this matter. The Procedural and Scheduling Order was later revised on May 25, 2005.

The Company filed its request for an increase in rates and charges on May 20, 2005, seeking to have the proposed revised rates effective June 20, 2005. Pursuant to its authority under O.C.G.A. § 46-2-25, the Commission suspended the proposed rates for a period no longer than five (5) months. The Commission has general supervision over gas companies under O.C.G.A. §§ 46-2-20(a) and 46-2-21. The Commission has "exclusive power to determine what are just and reasonable rates and charges to be made by any person, firm, or corporation subject to its jurisdiction" (O.C.G.A. § 46-2-23).

Atmos serves natural gas customers in and around the cities of Gainesville and Columbus, Georgia. In 1997, Atmos acquired through merger United Cities Gas Company. The areas served by Atmos in Georgia are the same service areas that were served by the United Cities Gas Company.

Pursuant to the Procedural and Scheduling Order the hearing of the Company's direct case was held on September 6th and 7th in Columbus, Georgia. Direct testimony by the Commission Adversary Staff and the Consumers' Utility Counsel was heard October 11th and 12th in Atlanta, Georgia. Atmos presented Rebuttal Testimony which was heard on November 3rd in Gainesville, Georgia and continued on November 4th in Atlanta. Recommendations by all parties were submitted to the Commission on November 10, 2005.

On November 17, 2005 the Commission entered an Order pursuant to O.C.G.A. § 46-2-25. Calculations showing the appropriate rate base for the test period, the appropriate return on investment, required operating income, net income available for return to the Company, income deficiency, the appropriate income expansion factor, and required revenue increase were shown on Appendix A to such Order. The Order further provided that a more detailed Order would follow.

On November 28, 2005, the Company filed its Petition for Rehearing, Reconsideration and Oral Argument. In the Petition, the Company alleged that the Commission's November 17, 2005 Order contained errors of fact and law, and was arbitrary and capricious. As such, the Company requested that the Commission rehear and reconsider its decision in this matter.

The Commission considered the Company's Petition for Rehearing, Reconsideration and Oral Argument at its December 20, 2005 Administrative Session. The Commission voted to reconsider its November 17, 2005 Order. Following discussion and consideration and rejection of a proposed Stipulation entered into by the Commission's Adversary Staff and the Company, the Commission voted to amend and modify that portion of its November 17, 2005 Order addressing depreciation.

Upon consideration of the evidence presented at the hearings in this matter and the recommendations made by all parties, the Commission herewith makes its findings, and issues this Order for the purpose of ruling on the Company's Petition for Rehearing, Reconsideration and Oral Argument and providing the more detailed Order referenced in the November 17, 2005 Order.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

I. TEST YEAR

As required by O.C.G.A. § 46-2-26.4, the Company filed its case using a test year with data to "reflect estimated operations during the 12 months following the proposed effective date of rates." Consistent with the proposed effective date for new rates and the statute, Atmos filed test year data for the twelve months ending June 19, 2006. The Company revised certain schedules in its filing on August 30, 2005 but did not adjust the test period. The Company based its projections for the test year on actual results for the historic year ending December 31, 2004, to which it made numerous ratemaking adjustments. The Commission finds as a matter of fact that the appropriate test year to be utilized in this proceeding is the twelve month period ending June 19, 2006.

II. REVENUE REQUIREMENTS

A. Rate Base

The Company proposed a total rate base of $76,105,495 in its original filing for the twelve month test period ending June 19, 2006. The Company revised the rate base projection to $76,125,960 in its revised filing on August 30, 2005 to correct one of several errors identified by the Adversary Staff. The following table represents the various components of rate base in the revised filing:

Plant in Service	$122,650,671
Less: Depreciation/Amortization Reserve	(48,777,996)
Construction Work in Progress	2,754,536
Miscellaneous Prepayments	192,289
Materials and Supplies	79,497
Storage Gas	9,728,624
Working Capital Required	1,089,261
Accumulated Deferred Income Tax	(9,119,222)
Accumulated Customer Deposits	(2,471,701)
Rate Base	$ 76,125,960

The Commission finds as a matter of fact that the appropriate rate base for the test period is $62,380,273 based on the modifications included in the following discussion. An additional description of the appropriate rate base is provided on Schedules 2, 2a, 2b, 2c and 4c of Appendix A, attached hereto and incorporated herein by this reference. Revenue Requirement valuations "By Issue" are summarized on Schedule 5 of Appendix A.

B. Remove Pipeline Replacement Program ("PRP") Rate Base Components (Refer to Appendix A, Schedule 4c)

Adversary Staff initially reduced Rate Base by $15,818,058 but then revised this amount to a reduction of $10,039,182 to conform to Mr. Petersen's Rebuttal Testimony relating the quantification of the PRP removal issue.

Based on the Commission's finding of fact in this order, consistent with both the Company's Rebuttal Testimony and Adversary Staff's revision, the Commission finds that the appropriate amount to use for the adjustment to Rate Base relating to removal of the PRP is a reduction to Rate

Base of $10,039,182. This translates into a Revenue Requirements reduction of $1,270,559 as shown in Appendix A, Schedule 5.

C. Accumulated Deferred Income Taxes ("ADIT") (Refer to Appendix A, Schedule 2a)

The Company proposed an ADIT liability balance of $9,119,222 in its original and revised filings in this proceeding. Part of the requested amount related directly to Georgia while others resulted in allocations from the Atmos Energy Corporation "(AEC") Shared Services, Mid-States and Eastern Regional Office divisions. These amounts were based on the Company's actual balances of ADIT on a per books basis as of September 30, 2004. The Company's filing assumed that all non-fixed asset related ADIT balances remained unchanged from September 30, 2004 through the Company's test year based on the premise that further amortization of current liabilities would be offset by new additions. The Company computed the per books amounts using a blended income tax rate of 38%, based upon a 35% federal income tax rate and an average state income tax rate of 3% for all its jurisdictions.

Adversary Staff proposed a number of separate adjustments to the ADIT liability balance to be included in the test year projection, totaling a net increase of $3,248,746 (refer to Appendix A, Schedule 2a), adjusted for recalculations related to the Company's re-calculation of Pipeline Replacement Program ("PRP") plant balances applied to adjusted depreciation rates. The net increase to the liability balance represents a decrease to rate base. The Company agreed that certain of the Adversary Staff adjustments were appropriate in various responses to discovery, but never revised its filing to correct these acknowledged errors.

The Adversary Staff's first ADIT adjustment was to reduce rate base by $306,088, recognizing the ADIT effect from the lower depreciation rates proposed by Adversary Staff. This adjustment was the product of multiplying the overall income tax rate of 38.9% times the accumulated depreciation adjustment noted below.

The Adversary Staff's second ADIT adjustment was to increase the liability balance by $944,593 related to a classification accounting error acknowledged by the Company in response to discovery for certain merger and integration costs. The Company provided corrected Minimum Filing Requirements ("MFR") schedules WP D1b-9 and WP D1b-9-1 in the same response to reflect the proper ADIT balance after the correction.

The Adversary Staff's third adjustment was to restate all ADIT balances using the actual combined federal and state income rate for Georgia of 38.9% instead of the 38% for AEC on a consolidated basis used by the Company for AEC book accounting purposes. The Adversary Staff noted in its Direct Testimony that the Company used the Georgia jurisdictional-specific 38.9% tax rate to compute the income tax expense included in operating income. The Adversary Staff calculated the rate base reduction associated with using the Georgia jurisdictional-specific income tax rate to be $238,354.

The Adversary Staff's fourth adjustment related to the removal of the deferred gas costs ADIT asset balance in the amount of $930,898. Adversary Staff argued that this balance should be set at a normalized amount of $0 for the test year, assuming neither an over recovery nor an under recovery of such costs through the Purchased Gas Adjustment ("PGA").

The fifth adjustment related to the classification error of certain "Non-Deductible UCG Acquisition" costs allocated to Georgia, resulting in a rate base overstatement of $98,375. This error was also confirmed by the Company through discovery but did not result in an ADIT change in the revised filing. The remainder of the recommended adjustments related to specific items noted by Adversary Staff to be allocable to non-regulated affiliates in other jurisdictions and was not related to providing utility service in Georgia. The total rate base reduction related to this group of adjustments as computed by Adversary Staff was $730,438.

The Company opposed the restatement of all ADIT balances using the combined federal and state income tax rate for Georgia of 38.9% on the basis that AEC computes its income tax on an average consolidated basis for all its jurisdictions, all of which have different tax rates.

The Commission finds as a matter of fact that the level of rate base should be reduced by $3,186,653 (refer to Appendix A, Schedule 2a) to reflect Adversary Staff's recommendations discussed above with the exception of the Accumulated Deferred Income Tax related to lower depreciation rates which necessarily differs due to the different levels of Depreciation Expense adjustments that arise from the Commission's correction of Adversary Staff's calculation of Removal Cost rates and rejection of the Adversary Staff's depreciation-related Shared Services adjustments, each of which is discussed below. Refer to Appendix A, Schedule 2a for a comparative calculation of this component of the overall adjustment to ADITs which results in an adjustment of $243,995 instead of the $306,088 amount referenced above

The Commission specifically finds that it is essential to use the same Georgia jurisdictional-specific income tax rate for both income tax expense and the ADIT amounts to ensure consistency within the test year. The Company's argument for the use of the Georgia jurisdictional-specific income tax rate when it increases income tax expense and revenue requirement and the use of an AEC consolidated income tax rate for ADIT when it reduces the ADIT liability amounts and increases rate base and the revenue requirement is not persuasive.

The revenue requirement impact of this adjustment is a reduction of $403,295, comprised of $372,417 due to Correction of the State Income tax rate and other corrections to rate base and $30,879 relating to adjustments for lower depreciation rates (Refer to Appendix A, Schedules 2a and Schedule 5, Group C Revenue Requirements by Issue presentation where this amount related to lower depreciation rates is netted against the Accumulated Depreciation adjustment (discussed below) of $79,382 for a net Revenue Requirements increase of $48,502).

D. Accumulated Depreciation (refer to Appendix A, Schedule 2b)

The accumulated depreciation balance is a direct function of the depreciation expense approved for a projected test year. In this case, the amount of accumulated depreciation included in the Company's filing, $48,777,996, represented the projected balance assuming the Company's proposed depreciation rates were in place for each asset class during the test year. This amount assumed also that the Company's filed allocation percentage for Shared Services costs was approved. Finally, this amount assumed the full roll-in of the Pipeline Replacement Program ("PRP") into base rates. The level of accumulated depreciation in the Company's filing was based on a thirteen-month average of estimated balances.

The Commission does not approve the depreciation rates as filed by the Company as described in the Operating Income section of this Order. However, as discussed below, the Commission does approve the Company's filed allocation percentages for Shared Services costs. As the result of the Commission's decision on the depreciation rates, the amount of depreciation expense allowed in the test year was decreased by $1,254,473 from the level proposed by the Company. Finally, the Commission disallowed the roll-in of the PRP into base rates. The accumulated depreciation effects of that decision are included in the PRP discussion and have no effect on the computations in this section of the Order.

Adversary Staff proposed use of the "half-year convention" by calculating an average of the beginning and ending year effects of the depreciation expense change to compute the proper level of accumulated depreciation. In this manner, the Commission finds as a matter of fact that the Company's test year accumulated depreciation should be reduced by $627,236, which has the effect of increasing rate base by the same amount. This amount excludes the effects of the PRP accumulated depreciation already removed because of the disallowed roll-in of the PRP to base rates. The $627,236 increase in the test year rate base results in an increase of $79,382 in test year revenue requirements. As discussed above in the "ADIT" section, this amount is shown in Appendix A, Schedule 5, Group C as the net amount of $48,502 after removing the ADIT revenue requirements impact of $30,879.

E. Cash Working Capital ("CWC")

The Company requested CWC of $1,089,261, representing the use of the one-eighth of Operating and Maintenance ("O&M") expense formula. The Company utilized this methodology in lieu of a lead-lag study, which is the preferred method of this Commission. In fact, through discovery the Company indicated that the last lead-lag study performed on behalf of the Company was for the Colorado jurisdiction in 2000. The Company justified the one-eighth of O&M expense approach by asserting that this was the acceptable methodology allowed in its most recent rate case, Docket No. 6691-U.

Adversary Staff disagreed with the Company's projection of CWC for a variety of reasons. First, contrary to the Company's assertion, the Commission previously rejected the Company's proposal to use the one-eighth formula in Docket No. 6691-U. The Commission has repeatedly stated its preference for a lead-lag study and did so in the Docket No. 6691-U Order. In the absence of a lead-lag study and as a transition measure, the Commission instead used a one-eighteenth of O&M expense formula to set the level of CWC in that docket.

Second, in the Virginia jurisdiction, rather than providing a lead-lag study in its most recent base rate proceeding (Case No. PUE-2003-00507), the Company simply requested a $0 CWC amount.

Finally, Adversary Staff asserted that the result of a properly developed lead-lag study would have likely produced a negative balance or $0 at most.

The Company did not address or dispute this adjustment in its Rebuttal Testimony.

The Commission finds as a matter of fact that the level of cash working capital should be set in this proceeding at $0, representing a rate base reduction of $1,089,261 and a reduction to test year revenue requirement of $137,854. The Commission reiterates its desire for the Company to perform a lead-lag study to support its level of proposed CWC in future proceedings.

F. Weighted Composite Factor (Refer to Appendix A, Schedule 2c)

In the Company's filing, the AEC Shared Services division gross plant, accumulated depreciation, accumulated deferred income taxes, Contribution to Work in Progress ("CWIP"), materials and supplies, and miscellaneous prepayment amounts were allocated to the Georgia rate division using a weighted average of all the AEC Shared Services division O&M expense composite allocation factors. This weighted average methodology was applied to the level of plant assets subject to allocation to determine the percentage allocated to Georgia. With the exception of the miscellaneous prepayments, the Company's filing allocated the Shared Services division's costs to Georgia at a rate of 3.63%. Miscellaneous prepayments were allocated to Georgia at a rate of 3.51% to match the allocation rate for the expenses that gave rise to the prepayment amounts. This latter rate of 3.51% was based on a weighted average of composite allocation factors as well but did not include a separate calculation involving the plant assets. These allocation rates were a result of the Company's assessment of the progress of the integration of the Company's TXU acquisition and reflected current allocation practices for non-regulated affiliates.

Adversary Staff recommended three separate forms of adjustments to the allocation rates noted above. Two of these were based on Staff's recommended adjustments to the O&M allocations, discussed below in the Operating Income section of this Order, while the third was based upon the level of plant assets included in the computation. Most of the O&M allocation adjustments were the result of the Company's continued integration of the TXU acquisition into its Shared Services division operations, while some related to the further sharing of costs with the non-regulated affiliates. As the integration of TXU progressed, more Shared Services division costs became fully allocable to a larger base including the two new TXU related operating divisions. The adjustment related to the level of plant assets resulted from reclassifying $84,092,865 in customer billing assets to a TXU allocable category instead of a non-TXU allocable category. This adjustment resulted in fewer plant costs being allocated to Georgia ratepayers. Based upon its recommended individual adjustments, the Adversary Staff recomputed the allocation percentages to Georgia to be 2.25% and 2.30% compared to the allocation percentages of 3.63% and 3.51%, respectively, as requested by the Company. This resulted in a recommended rate base reduction of $887,465.

As described in the Operating Income section of this Order, the Company opposed any changes to the AEC Shared Services division O&M expense allocation rates to reflect further integration of the TXU Gas acquisition, citing increased AEC Shared Services division costs that essentially offset the reductions in the allocation factors. The Company also opposed the $84,092,865 adjustment related to customer billing assets mentioned above, asserting that the newly developed Mid-Tex division is using an entirely new billing system, "Advantage", and not the existing, "Banner", billing system that was represented by this level of costs.

The Commission agrees with the Company that its allocation methodology as filed is correct and appropriate (as discussed below in the Operating Income Section). Therefore, Adversary Staff's proposed changes to the O&M allocations, which are used in part by Adversary Staff to calculate the adjusted Rate Base allocators, are rejected. Further, the Commission agrees that Adversary Staff's adjustment related to the level of plant assets resulting from reclassifying $84,092,865 in customer billing assets to a TXU allocable category instead of a non-TXU allocable category is incorrect since the Mid-Tex Division (TXU) has its own separate billing system. Therefore, the Commission finds as a matter of fact that Adversary Staff's proposed reduction to Rate Base of $887,465 to reflect Adversary Staff's recommended allocation percentage changes to the Company's Shared Services division rate base allocations is rejected.

G. Injuries and Damages ("I&D") Reserve

The Company carries a reserve for I&D on the books of its Shared Services division but did not include Georgia's allocable share as a reduction to rate base in this proceeding. Adversary Staff recommended that the Company's rate base be reduced by $57,828 for Georgia's allocable share of this reserve balance.

In Docket No. 6691-U, the Commission made an adjustment to reduce rate base for the portion of the Company's I&D reserve allocated to Georgia. In that Order, the Commission determined that the I&D reserve balance was "ratepayer–contributed capital to the Company, on which a return should not be earned."

The Company did not address or dispute this adjustment in its Rebuttal Testimony.

The Commission finds as a matter of fact that rate base should be reduced by $57,828, representing the portion of the Company's I&D reserve balance allocable to Georgia. Test year revenue requirement is reduced by $7,319.

III. OPERATING INCOME

The Company proposed an operating income amount, before the proposed increase, of $4,266,645 in its original filing for the twelve month test period ending June 19, 2006. The Company revised the operating income projection to $4,166,836 in its revised filing on August 30, 2005. The following table represents the various components of operating income from the schedules in the revised filing:

Operating Revenues	$19,947,382
Operating Expenses:	
Operation and Maintenance Expenses	8,714,086
Depreciation and Amortization Expense	4,496,707
Taxes Other Than Income	1,118,283
Income Taxes	1,278,451
Interest on Customer Deposits	173,019
Total Utility Operating Expenses	15,780,546
Net Utility Operating Income Before Interest Expense	$4,166,836

The Commission finds as a matter of fact that the appropriate available operating income level for the test period is $4,471,869 based on the modifications included in the following discussion. An additional description of the appropriate available income level for the test period is provided on Schedule 4, 4a, 4b, 4c, 4d and 4e of Appendix A. Revenue Requirement valuations "By Issue" are summarized on Schedule 5 of Appendix A.

A. Depreciation Expense (Refer to Appendix A, Schedule 4b)

The Company proposed a small decrease in the composite depreciation rate applicable to its Georgia *in situ* plant from 2.96% to 2.87%, based on a depreciation study submitted by its witness Donald Roff. Mr. Roff advocated the use of the Equal Life Group ("ELG") methodology for computing account remaining service lives, and he proposed what he termed the "traditional" procedure for computing the cost of removal allowances that he would incorporate into depreciation rates. Applied to the Company's test year average depreciable plant balance of $112,731,974, Mr. Roff's recommended depreciation rates would have reduced test year depreciation by $90,767.

Unmentioned in any of the Company's initial testimony was a further increase in depreciation expense relating to shared services plant. The Company proposed test year depreciation expense for this plant of $1,098,939, almost double the $596,104 expense that results from application of the present depreciation rates for this plant.

Adversary Staff recommended that depreciation be separated from removal cost accounting. It based this recommendation on the requirements of the Statement of Financial Accounting Standards ("SFAS 143") and Order No. 631 of the Federal Energy Regulatory Commission ("FERC"), and the pronouncements of the Securities and Exchange Commission ("SEC"), all of which require that accruals for removal costs be broken out and reported separately from accruals for depreciation.

Adversary Staff recommended the same procedure for calculating removal cost allowances that it had proposed in each major rate case since Docket No. 4007-U in 1990. That procedure, which involves calculating lifetime removal costs in current, rather than future costs, underlies the removal cost allowances used by Georgia Power Company, Savannah Electric & Power Company and Atlanta Gas Light Company.

Adversary Staff presented an independent study of Atmos' plant account and service life parameters, from which it developed depreciation rates somewhat lower than those sought by the Company. Staff's "pure" (exclusive of removal costs) composite depreciation rate was 1.84% and its composite removal cost rate was 0.23%, which combined depreciation/removal cost accrual rate of 2.07%.

Adversary Staff recommended that the ELG procedure be disapproved. It is not used by any other regulated Georgia gas or electric utility. Moreover, the unevenness of retirements from even the largest of Atmos' plant accounts makes the fundamental assumption of ELG unsubstantiated, which is that retirements follow exactly the pattern of the Iowa curve selected for each account.

Finally, Adversary Staff recommended that the proposed increases in shared services depreciation expense be disallowed on the grounds that the Company failed to support these increases.

The Commission finds that the transparency of the Company's depreciation and removal cost accounting would be substantially improved if these two functions were separated. Accordingly, it directs the Company to report annually the subsidiary records of removal cost accounting that FERC has required in its Order No. 631. The accumulated accruals for removal costs should reconcile with the Georgia portion of the regulatory liability for removal costs that the Company must declare pursuant to SEC instructions.

The Commission finds that the Adversary Staff's removal cost formula (as corrected in Appendix A, Schedules 4b1-3, summarized in Depreciation Schedule 4b) is appropriate. This formula currently underlies the removal cost allowances of the three other major regulated Georgia gas and electric utilities. It is also more consistent with sound economic and accounting principles, such as those employed in SFAS 143, because it expresses removal costs in current, rather than distant future dollars.

The Commission also adopts Adversary's Staff's life and curve shape parameters, and consequently its recommended depreciation rates. As Adversary Staff pointed out, the Company's recommended service lives did not always comport with the results of its own depreciation study (King at 17).

The Commission will not adopt ELG depreciation, as it is not used anywhere else in Georgia for regulated utilities.

The Commission agrees that the Company failed to support its proposed doubling of depreciation expense for shared services plant. No witness mentioned, or sponsored, these increases, and the underlying them was revealed only in the discovery phase of the case.

The Company's claims that the Commission has violated its own rules and violated regulatory accounting rules are without merit. Atmos states that the Commission violated Commission Rule 515-3-1-.10, which requires the retention of records in conformity with the FERC system of accounts. (Petition, p. 5). The Commission, however, is not improperly commingling regulatory and financial accounting as Atmos charges. To the contrary, the Commission is adopting Adversary Staff's position on depreciation, which recommended that the Commission direct Atmos "to report annually the subsidiary records of removal cost accounting the FERC has required in its Order No. 631." (Adversary Staff Proposed Order, p. 12). The Commission finds that its order is in compliance with the FERC Uniform System of Accounts. Atmos is incorrect in its allegation that the Commission order violated FERC's Uniform System of Accounts ("USOA") because the USOA does not state that the removal costs allowance charged to expense shall be calculated as the percentage of removal cost to plant retired.

The Company's claim that the Commission has significantly underestimated total lifetime removal costs by divorcing retirements from actual removal costs is incorrect. The methodology proposed by Adversary Staff, and adopted by the Commission, properly recognizes recent removal cost experience, but it does not project the inflation of recently retired plant into the future.

The Company also claims that the Commission incorrectly imputed net salvage allowances and deferred recovery of net salvage to future generations of customers. (Petition, p. 6). This claim misconstrues the methodology adopted by the Commission. The Commission did not impute or defer recovery of net salvage to future generations. Rather, the Commission order prevents the front-loading of net salvage recovery to the present generation of ratepayers. In contrast, Atmos proposed a methodology that would charge distant future removal costs, inflated to future price levels, to present ratepayers in undiscounted dollars.

The Company's objection that the "Commission's approach to net salvage relies on valuation principles and therefore violates generally accepted accounting principles with respect to depreciation accounting" is unclear. (Petition, p. 6). The Commission's procedure properly allocates the lifetime cost of removal of each account, expressed in current dollars, over the life of each account. This procedure is consistent with cost allocation principles and with generally accepted accounting principles.

The Commission finds as a matter of fact that depreciation expense should be decreased in the amount of $1,254,473 related to depreciation rate adjustments for the Georgia operations and the disallowance of depreciation rate modifications for the shared services plant. This $1,254,473 reduction in Depreciation Expense results in an after-tax Operating Income increase of $766,483 which translates into a Revenue Requirements reduction of $1,254,473.

B. Gas Technology Institute ("GTI") Research

The Company proposed a "surcharge" of $119,000 to fund research and development ("R&D") through GTI. However, unlike a typical surcharge, the Company reflected this amount as an increase to O&M expense included in the base revenue requirement. Thus, the Company's request does not constitute a surcharge.

The R&D efforts provided by GTI are intended to ultimately benefit gas consumers. Funding for GTI R&D efforts was previously provided through FERC-authorized surcharges on transported gas over interstate pipelines, but the surcharges were discontinued by the FERC in August 2004 and the funding authority transferred to state jurisdictions. The Company's witness on this issue, GTI Director of State Regulatory Programs, Ronald Edelstein, testified that the GTI R&D expense was justified because it resulted in economic benefits to consumers of $8 for every $1 in cost incurred, which he based on a recent independent study of actual expenditures and actual benefits.

The Adversary Staff agreed that the Commission should approve the additional expenditures, but with certain conditions. The first condition was that the Commission should require at least a 1 to 1 ratio of O&M cost savings to cost expenditures. One of the benefits pointed out by Mr. Edelstein was the lowering of gas local distribution company operating and maintenance costs. The second condition was that the Company should be required to spend this amount each year with GTI and that some type of reporting requirement be established to verify such expenditures.

The Commission recognizes the value of R&D efforts, and the benefits such efforts provide to the Company's ratepayers. However, the Commission notes that Schedule B-4 (membership fees and dues included in revenue requirements) of the Minimum Filing Requirements filed by the Company lists over $327,000 in dues provided by the Company's ratepayers. Approximately 70% of these dues are being paid to entities such as the American Gas Association, the Institute of Gas Technology and the Southern Gas Association, which currently perform R&D functions. The Commission further notes that neither the Company nor its shareholders is willing to provide any funding for these R&D efforts. The Company has not met its burden to demonstrate that the funds it seeks to recover from ratepayers in connection with GTI provides a benefit to ratepayers independent from what is already being realized through the R&D expenses ratepayers fund. As such, the Commission finds as a matter of fact that the Company should not be allowed to recover $119,000 from ratepayers to fund GTI for R&D on behalf of the ratepayers. This $119,000 reduction in O&M Expense results in an after-tax Operating Income increase of $72,709 which translates into a Revenue Requirements reduction of $119,000.

C. Mid-States Consolidation Savings

Atmos is presently evaluating the amount of savings that it can achieve by consolidating certain functions between its Kentucky Operating division and the Mid-States Operating division, the latter of which serves Georgia. The Company already has consolidated the President's position between the two Operating divisions, resulting in savings that were not reflected in the Company's filing. Mr. Paris, President of the Kentucky/Mid-States divisions, described in his pre-filed testimony the February 2005 consolidation of the division President's position. The consolidation occurred after the retirement of the former Mid-States division President, Mr. Blose. In response to Adversary Staff's discovery, the Company quantified the estimated consolidation annual savings to Georgia as $27,700.

The Adversary Staff recommended a decrease to the Company's operating expenses for $27,700 since this change was known and measurable and the savings would be in effect in the test year.

The Company did not address or dispute this issue in its Rebuttal Testimony.

The Commission finds as a matter of fact that operating expenses be decreased by $27,700 to account for the anticipated savings related to the consolidation of the division President's position. This $27,700 reduction in Operating Expenses results in an after-tax Operating Income increase of $16,925 which translates into a Revenue Requirements reduction of $27,700.

D. Investment Tax Credit ("ITC")

AEC acquired the Company's unamortized ITC balance when it acquired United Cities Gas in 1997. For ratemaking purposes, an unamortized investment tax credit provides a decrease to income tax expense in the year of amortization. The Company did not include a reduction to the projected income tax expense for ITC amortization in its filing. In response to Adversary Staff's discovery, the Company quantified the ITC amortization expense that should have been allocated to Georgia as $49,799.

The Commission has consistently incorporated the ITC amortization as a reduction to the base revenue requirement. The Company did not address or dispute this issue in its Rebuttal Testimony.

The Commission therefore finds as a matter of fact that available operating income should be increased by $49,799 to account for the ITC amortization in the test year. This translates into a reduction to Revenue Requirements in the amount of $81,504 ($49,799/0.611).

E. Pipeline Replacement Program (Refer to Appendix A, Schedule 4c)

Based on the Commission's finding of fact in this order, in addition to the PRP-Rate Base adjustment above, both operating revenues and operating expenses associated with the PRP should be removed from the Company's test year operating income projection. The Company did not quantify this amount in its initial filing but did provide a detailed calculation in Mr. Petersen's Rebuttal Testimony Schedule THP-R1. Based on this calculation as well as evidence in the case including the Company's filed MFR Appendix F-3 ("Rates and Revenues for Test Year Ended

June 19, 2006"), Operating Revenues associated with the PRP included in the Company's projected Operating Income amounted to $673,112. Operating Expenses associated with the PRP and representing the net of the O&M expense baseline savings and the depreciation expense associated with the PRP in the test year, amounted to $3,649.

Adversary Staff, in response to Mr. Petersen's Rebuttal Filing, Schedule THP-R1, incorporated the PRP Operating Expense adjustment of $3,649 in its Revenue Requirements calculation as well as the PRP-Rate Base adjustment discussed above but did not include the PRP Operating Revenue adjustment of $673,112 in its revised Revenue Requirements calculation. Adversary Staff did not address the PRP-Operating Revenue adjustment in their Brief (Proposed Order).

The Commission finds as a matter of fact that, consistent with Mr. Petersen's Rebuttal Testimony Schedule THP-R1 quantifying the impact of disallowing the PRP roll-in to base, operating revenues in the amount of $673,112 and operating expenses in the amount of $3,649 should each be removed from the Company's projection of test year operating income. The net impact of these adjustments, a decrease in Operating Income in the amount of $669,463 before-tax and $409,042 after-tax., translates into a Revenue Requirements increase of $669,463. This adjustment removes the entire operating income effect of the PRP included in the Company's filing in Docket No. 12509-U.

F. Uncollectible Accounts Expense (Refer to Appendix A, Schedule 4d)

The Company removed $861,523 in uncollectible accounts expense from the base revenue requirement in this proceeding to include as gas costs in the Company's PGA. The Commission is denying the Company's request regarding the modification to the PGA therefore, operating expenses for the projected test year should be increased by the same amount. The Commission finds that this $861,523 increase in Operating Expenses results in an after-tax Operating Income decrease of $526,391 which translates back to the Revenue Requirements increase of $861,523.

In addition to this change regarding PGA-designated uncollectible accounts, Adversary Staff proposed a change to the appropriate level of uncollectible accounts expense that should be applied to total customer revenues and recovered through the base revenue requirement. Assuming the additional expense of $861,523 mentioned above, the Company included $1,069,511 in uncollectible accounts expense in its filing or approximately 1.5% of revenues. Adversary Staff described the recent history of actual customer account write-offs in Georgia as well as all the Atmos utility divisions as the basis for its recommendation to set the uncollectible accounts expense at 0.6% of total revenues. This recommendation was based on choosing the high end of the recent year trends that ranged from 0.29% to 0.59%. In addition, the Adversary Staff recommended that the Commission apply the 0.6% rate to the requested base revenues in the Company's filing and to PGA revenues, which the Staff projected using the Company's test year gas cost from its quantification of the storage gas amounts included in rate base. The Adversary Staff recommended an uncollectible accounts expense amount of $504,788, or a reduction in expense of $564,723 from the total requested by the Company, including the amount that it requested be recovered through the PGA.

Finally, the Adversary Staff recommended another adjustment to decrease uncollectible expense to reflect their proposed base rate reduction. Based on Adversary Staff's proposed revenue requirement decrease of $2,101,298, the resulting decrease for uncollectible expense was $12,608, based on application of the 0.6% rate recommended above to the difference between the Company's revised requested increase and the Commission's approved reduction.

The Commission does not find Adversary Staff's proposed uncollectible Expense Ratio of 0.6% to be unreasonable and in fact considers it to be an appropriate factor to apply in the determination of the **incremental level** of Uncollectible Expense associated with the ($409,277) incremental increase in Test Year Revenues approved by this Order. The Commission finds as a matter of fact that application of the 0.6% uncollectible expense ratio to incremental test year revenues of $409,277 results in a $2,456 increase in Operating Expenses for an after-tax Operating Income decrease of $1,500 which translates into a Revenue Requirements increase of $2,456.

However, for the determination of an appropriate, overall level of Uncollectible Expense associated with Total Customer Revenues included in the Test Year, the Commission used not only Adversary Staff's proposed rationale in arriving at, and applying a 0.6% uncollectible expense ratio resulting in an Adversary Staff-proposed amount for Uncollectible Expense of $504,788, but also considered other factors including as a starting point the Company's filed amount as adjusted to include the PGA-Bad Debt summing to $1,069,511, actual write-offs, the Company's recent improvements in collections, as well as recent and projected increases in natural gas bills.

According to the Company (Cagle Rebuttal P16 L 16-19), actual net write-offs were $565,252 in Fiscal Year 2003 and $762,452 in Fiscal Year 2004. Per Adversary Staff's calculations (Kollen Direct P16 L25-27), actual write-offs were $792,167 in fiscal year 2004 and $500,452 in calendar year 2004. Based on the these factors, aside from the separately-calculated incremental level of Uncollectible expense associated with the Test Year Revenue increase discussed above, the Commission finds that an amount of $750,000 is a reasonable estimate of uncollectible expense which the Company could incur in the Test Year. The Commission finds that after subtracting this amount from the Uncollectible Expenses as filed with PGA-Uncollectibles added-back ($1,069,511), results in a decrease in Uncollectible Expenses in the amount of $319,511 for an after-tax Operating Income increase of $195,221 which translates into a Revenue Requirements reduction of $319,511.

In summary, the Commission therefore finds as a matter of fact that the net increase to the Company's filing amount for uncollectible expenses should be $544,468 (Refer to Appendix A, Schedule 4d). These additional expenses, as discussed above, consist of the add-back of the expenses related to the proposed modification to the PGA of $861,523, reduced to reflect a reasonable ($750,000) level of Uncollectible Expense associated with test year revenues resulting in an adjustment of $319,511, increased by $2,456 to reflect the 0.6% uncollectible expense ratio advocated by Adversary Staff applied to the $409,277 increase in test year revenues authorized by this Order. The combined impact of these adjustments is an after-tax decrease in Operating Income in the amount of $332,670 for an overall Revenue Requirements increase of $544,468.

G. Escalation Factors

The Company used a variety of escalation factors to increase O&M expenses and taxes other than income ("other taxes") from the historic year to test year levels. The Company increased all labor related expenses to coincide with the Company's budgeted labor increases for each fiscal year end of 3.5%. The Company did not project a change in the number of employees from the historical year to the test year. The Company relied upon projections from its actuary to calculate increases for its Pension, Medical and Dental, Other Post Employment Benefits and Supplemental Executive Benefits Plan expenses. Property Taxes were increased using a 5% budget factor, while Department of Transportation tank fees were escalated using a factor based on historic trends. All other O&M expenses and other taxes were escalated at a rate equal to the projected Consumer Price Index ("CPI").

Adversary Staff recommended that these escalation factors be adjusted to reflect productivity gains as offsets to the inflationary increases. Adversary Staff noted that the Company has demonstrated an ability to control cost growth through productivity gains achieved through investment in technology and other process improvements. Adversary Staff provided a history of the decrease in actual O&M expenses incurred by the Georgia jurisdiction over the most recent five year period. In addition, Adversary Staff highlighted the fact that the national productivity increases over the last five years have more than outpaced the CPI inflationary increases. For these reasons, Adversary Staff recommended a reduction of $368,137 in the Company's inflation-based projection of O&M expenses and other taxes for the test period.

The Company did not address or dispute this adjustment in its Rebuttal Testimony.

The Commission finds as a matter of fact that test period O&M and other taxes expenses should be reduced by $368,137 to reflect productivity gains against the inflation escalations for the test year. This $368,137 reduction in Operating Expenses results in an after-tax Operating Income increase of $224,932 which translates into a Revenue Requirements reduction of $368,137. The evidence on the whole record reflects that the inflationary expenses that the Company claims it will incur will be offset by national productivity increases. Therefore, the Company does not need the requested allowance related to inflation in order to achieve a fair return.

H. Composite Factor Allocations (Refer to Appendix A, Schedule 4e)

As described in the Company's Cost Allocation Manual, the Company employs a multi-step cost allocation process to allocate costs to the Georgia jurisdiction that are initially incurred at the Company's other organization levels. Costs incurred at the AEC Shared Services, Mid-States Operating, and Eastern Regional Office divisions are allocated to Georgia through the use of various allocation factors, predominantly composite allocation factors and number of customers factors. The composite allocation factors are based on a weighted average of three ratios computed for each Operating division or affiliate compared to all Operating divisions and selected affiliates in total. The three ratios are gross property, plant and equipment, average number of customers, and total direct operation and maintenance expense.

The Company's filing included an allocation of O&M expenses, other taxes, depreciation expenses and certain rate base items from the AEC Shared Services division based primarily upon an average of the composite allocation factors assigned to each of the AEC Shared Services department cost centers. In the filing, the Company used the allocation percentages relied upon to allocate costs to Georgia reflecting the first and immediate stage of integration of the TXU Gas acquisition, which occurred on October 1, 2004. Atmos separated the TXU Gas acquisition into two new operating divisions, the Mid-Tex and Atmos Pipeline–Texas. To account for the stage of integration immediately following the acquisition, the Company's Shared Services division created additional composite factors to account for the partial integration of services provided by certain cost centers. The new composite factors reflected cost center service levels of 0%, 25%, 50%, or 100% based on management's assessment of the status of the integration.

The Adversary Staff disagreed with the composite allocation factors used by the Company in its filing because the integration of the two new Operating divisions was projected to be completed within the test year. The Adversary Staff noted that most of the composite allocation factors had already been changed to reflect the increased level of integration in the actual allocation process. Some of these changes occurred in May 2005 while others occurred in October 2005. Based upon these actual allocation changes either before or near the beginning of the test period, Adversary Staff recommended that the test period allocations of costs be reduced to reflect the changes already implemented and that were known and measurable for the test year. This was based on the assumption that fewer costs were actually being allocated to the Atmos divisions and affiliates than existed prior to the acquisition as more costs were allocated to the new TXU related divisions. The effects of Adversary Staff's recommendation were to reduce test year rate base by $875,695 (separately discussed in the Rate Base section above) and operating expenses by $868,492 ($617,969 for the O&M allocations and $250,523 for Depreciation and Other Taxes).

In addition, Adversary Staff recommended that the weighted average composite allocation be further adjusted slightly to reflect the allocation of certain cost center costs to non-utility affiliates that were improperly not allocated a portion of certain Shared Services division cost center costs. The effects of this recommendation were to reduce the test year rate base by $11,770 (separately discussed in the Rate Base section above) and operating expenses by $16,309 ($13,072 for the O&M allocations and $3,237 for Depreciation and Other Taxes).

The Company stated in Rebuttal Testimony that Staff had inappropriately applied updated allocation factors to reflect the effects of the recent acquisition of the Company's Mid-Tex and Atmos – Pipeline Texas divisions <u>without also considering changes in costs</u>. Company Witness Cagle stated that the Company's shared services operations are in a time of transition and that, "while shared services allocation percentages are decreasing to Georgia, the dollar amount to be allocable to all of the various operations are increasing and increasing pretty dramatically." Mr. Cagle further stated that it is "inappropriate to change an allocation factor in the filing without looking at the costs that are being allocated and what those costs might be". He stated "at the time the minimum filing requirements were being assembled, I really couldn't -- and there really wasn't a -- a firm definite this is exactly the way we're going to be doing this and this is exactly the time line that we're going to use to incorporate whatever services that Mid Tex needs into shared services." It is however reasonable, he stated, to build in an amount of known savings as of the filing date and to determine allocated costs in the filing based upon the level of costs and factors known at the time of filing. This is the "reasonable approach" that was applied by the Company in the preparation of their filing.

The Commission agrees with the Company on this issue and recognizes the **interdependency** of shared service allocation factors and their underlying costs. Therefore, the Commission finds as a matter of fact that Adversary Staff's adjustments for shared allocation factors are hereby rejected.

I. Atmos Energy Services, LLC ("AES") Charges

AES is a non-utility subsidiary of the Company that began providing Georgia with gas procurement services in May 2004. Prior to that time, similar services were provided to Georgia through the Company's Shared Services and Mid-States Operating divisions. The Company requested $203,971 for AES affiliate costs in its revenue requirement including an adjustment of $93,606 to annualize historic year expenses for a full year.

Adversary Staff did not question whether AES charges should be included in the Company's revenue requirement but did take exception to the level of includable costs. Adversary Staff asked the Company through discovery to quantify the annual savings from the discontinuance of these services from the Company's Shared Services and Mid-States operating divisions that would have been allocated to Georgia. The Company quantified these cost savings as $47,026. Adversary Staff recommended that the Commission approve only the $47,026 in AES expenses to coincide with the amount that would have been allocated to Georgia had the Company's Shared Services and Mid-States operating divisions continued to provide such gas procurement services. This recommendation represented a decrease to the Company's requested level of operating expenses of $156,945.

In its Rebuttal Testimony, the Company claimed that Staff had not fully compared the costs of AES with the historical gas supply costs and that Staff used the limited response to STF-5-50 inaccurately as a benchmark. The response to that particular request dealt only with individuals that transferred from Atmos to AES. Staff did not take into account the retirement of key gas supply personnel or any additional responsibilities that those employees that transferred have absorbed in the current AES business model. The cost that AES charges is an all encompassing figure that includes employees at all levels. The majority of AES charges are a result of direct charges that result from the employees' workload per state. Only those costs that are general in nature and/or cannot be directly assignable to a particular state are allocated. Besides the inaccurate comparisons of personnel cost vs. total cost, Staff did not acknowledge that AES has improved efficiencies, standardized processes and increased the job functions and responsibilities of the historical gas supply department. Examples of increased job functions would include but not be limited to third party supply and transportation management, gas cost reporting, state regulatory support, capacity planning, load forecasting and support to AEC in FERC regulatory matters. The Company, in Rebuttal Testimony, further states that AES has increased the focus and resources to all AEC operating divisions in response to gas supply market volatility, industry credit issues and supply shortages that the industry has experienced over the last several years. Gas supply and capacity costs are AEC's largest expense and it is the Company's belief that it was prudent in its decision to employ more resources to manage these costs.

Additionally, the Company in Rebuttal Testimony discussed a study performed by Baryenbruch & Company, LLC to investigate the costs that AES charged AEC in Virginia. It was determined that costs charged to AEC in Virginia by AES were priced at the lower of cost of market. The Company maintains that the assumptions and facts underlying the Virginia study are "the same" for all ATMOS jurisdictions, including Georgia. This conclusion is further reinforced per the Company in that the Municipal Gas Authority of Georgia ("MGAG") was included for purposes of comparison in the Baryenbruch study. Given that MGAG performs similar services as AES to many municipal gas companies in Georgia, the favorable result of the study showing that MGAG's services in Georgia are priced at $0.08/Dth, whereas AES costs for Georgia would be approximately $0.02/dth ($203,971/10,090,188 Dth) if billed on a per Dth basis, provides a more reliable measure of AES cost efficiencies than Adversary Staff's limited analysis..

The Commission finds as a matter of fact that, although the Company should have responded initially in a more complete manner to Adversary Staff's data request as done in its Rebuttal Testimony on this topic, the Commission finds that the Company's support for this issue is satisfactory in this case and that Adversary Staff's proposed adjustment to AES expenses is therefore rejected.

J. Rate Case Expenses

The Company projected that it would incur $300,000 in costs associated with this rate proceeding and proposed the deferral and amortization of this amount at $100,000 annually over three years.

Adversary Staff did not question the amount of the deferral request but did recommend use of a five-year amortization period, which would reduce test period expenses by $40,000. Adversary Staff pointed to the fact that even though the timing of the Company's next base rate proceeding could not be predicted with certainty, the last base rate proceeding occurred nearly ten years prior to this proceeding. Adversary Staff also noted that if the Company filed another base rate case before the five year amortization period was completed, it retained the option to recover the unamortized deferred amounts from this case in that proceeding.

The Company did not address or dispute this adjustment in its Rebuttal Testimony.

The Commission finds as a matter of fact that the projected rate case expenses of $300,000 should be deferred and amortized over a period of five years at $60,000 annually. The effect of this adjustment is to reduce Operating Expenses by $40,000 ($100,000 based on a 3-year amortization as included in the Test Year less $60,000 based on a 5-year amortization). This $40,000 reduction in Operating Expense results in an after-tax Operating Income increase of $24,440 which translates into a Revenue Requirements reduction of $40,000.

IV. COST OF CAPITAL

A. Rate of Return

The Company sought in its filing to be permitted an overall rate of return on rate base of 8.84%. The Company made no changes to this request after the original filing. The various components of the Company's request are detailed in the table that follows.

	Capital Ratio	Component Costs	Weighted Avg Cost	Grossed Up Cost
Short Term Debt	0.00%	0.00%	0.00%	0.00%
Long Term Debt	50.00%	5.67%	2.84%	2.84%
Common Equity	50.00%	12.00%	6.00%	9.82%
Total Capital	100.00%		8.84%	12.65%

B. Capital Structure

All financing activities for the Georgia jurisdiction are performed at the AEC corporate level, thus the Company's rate filing reflected the Company's corporate level cost of capital. The Company proposed a hypothetical capital structure of 50% long-term debt and 50% common equity, based on its permanent capital structure objectives of 50% debt and 50% common equity. The Company did not include a separate component for short-term debt in this proposed hypothetical structure. The Company also proposed a hypothetical capital structure because of the recent volatility in its actual structure. The Company noted that its overall capital structure at September 30, 2004, before the TXU Gas Company acquisition, consisted of 43.35% total debt and 56.65% common equity. Those percentages changed drastically to 59.05% long-term debt, 0.75% short-term debt and 40.20% common equity by December 31, 2004 as a result of financing activities related primarily to the acquisition. For this reason, the Company argued the use of a hypothetical structure to match its permanent target goals. Dr. Murray concurred with the Company's target for the percentage of common equity, suggesting that the 50% requested was not only appropriate but below the average for a comparable group of companies as reported by Value Line.

The Adversary Staff agreed that the Commission should use a hypothetical capital structure due to the volatility in historic year ratios primarily related to the TXU Gas Company acquisition. However, the Adversary Staff noted that the Company's recent financial forecasts did not project achievement of this goal until sometime after fiscal year 2008, which meant that its actual debt capitalization would be greater than its hypothetical ratio for the next three years. This would have led to a significant mismatch between the Company's actual capitalization and its hypothetical capital structure and an excessive revenue requirement. In addition, Adversary Staff concluded that the Company's proposed zero level of short-term debt was unreasonable in light of the Company's continued use of short-term debt to finance gas inventories and other working capital requirements. The Company stated through discovery that it periodically uses short-term debt for such purposes.

The Adversary Staff recommended a hypothetical capital structure reflecting a 10% level of short-term debt with the residual allocated equally at 45% long term debt and 45% common equity. That formula computed the portion of the rate base constituting the working capital requirement, which includes the non-permanent component of stored gas inventories, cash working capital, prepayments, and construction work in progress. As such, the Adversary Staff argued that 10% was a conservative estimate for short-term debt.

Ms. Sherwood stated in the Company's Rebuttal that short-term debt was used only for seasonal gas purchases and that a zero level during much of the year helped to lower the monthly average of short-term debt. However, Ms. Sherwood did concede in Rebuttal that a capital structure consisting of 5% short-term debt, 50% long term debt and 45% common equity would not be unreasonable, in light of the fact that it might take some time before the Company could once again reach its permanent capital structure goal of 50% total debt. This concession represented the same total debt level as proposed by Adversary Staff with the only difference being the level of the short-term and long-term debt components.

The Commission finds as a matter of fact that the capital structure that should be used for this proceeding should be 5% short-term debt, 50% long-term debt and 45% common equity.

C. Cost of Short-Term Debt

As stated earlier, the Company did not include a short-term debt component in its filing. Thus, the Company did not suggest a proper short-term debt rate for this proceeding.

The Adversary Staff proposed the use of 3.85% as the reasonable cost of short-term debt related to the test year. This percentage was based on the three month LIBOR forward curve rate as of September 9, 2005. The three month forward curve as of that date was used to be consistent with the use of an average test year rate base.

In conjunction with its proposal to use a 5% short term debt component in its hypothetical capital structure in its Rebuttal Testimony, the Company proposed a 4.74% cost of short-term debt based upon a more recent three month LIBOR forward curve rate, including the borrowing spread under its revolving credit agreement.

The Commission finds as a matter of fact that the short-term debt rate used in this proceeding capital structure should be 4.74%.

D. Cost of Long-Term Debt

The Company proposed a long-term debt cost rate of 5.67% based upon its projected outstanding debt issues during the test year. These projected debt issues matched the Company's debt issues at the end of the historic year and did not reflect any re-financings or other known and measurable redemptions.

The Adversary Staff proposed two adjustments to the Company's quantifications to reduce the average long-term debt cost rate to 5.55%. First, the Adversary Staff recommended the removal of several debt issues that actually were retired on June 30, 2005, the first month of the test year. Second, Adversary Staff recommended the removal of certain high-cost debt issues that had not been redeemed or refinanced due to agreements made in another jurisdiction related to the 1993 AEC acquisition of Greeley Gas Company.

The Company agreed with the adjustment to remove the debt issues that actually were retired during the test year and the Commission finds that removing the retired issues results in an adjusted cost of long term debt of 5.5527451%.

The Commission finds as a matter of fact that the long-term debt rate for the test period should be set at 5.5527451%. A detailed description of the calculation of such long-term debt rate is provided on Schedule 3A to Appendix A.

E. Common Equity

The Company proposed a cost of common equity of 12.0%, based on an analysis using Discounted Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) analyses. In determining its DCF cost of equity estimate, the Company relied on four separate DCF analyses of the market data of Atmos Energy as well as sample of gas distributors selected to be similar in risk to Atmos. The four DCF estimates were based on either a current dividend yield or a 52-week average dividend yield and a growth rate based on either analysts' published earnings growth projections or on the Company's own analysis of historical and projected earnings growth rates. The average DCF results presented in Dr. Murry's direct testimony ranged from 7.7% to 13.8%.

In addition to several DCF analyses, the Company cost of capital witness presented the result of two CAPM analyses. The Company's CAPM analyses included upward adjustments to account for the fact that Atmos Energy, although it is now the largest gas distributor in the U.S., is deemed to be a "small" company, which requires an additional "size premium" to account for increased risk. The premise of the Company's "size premium" is based assumption that smaller companies are considered more risky investment than larger companies. Historical return data shows small companies have, on average, earned higher returns than have larger companies. The average CAPM results presented in Dr. Murry's direct testimony ranged from 10.9% to 12.5%.

Adversary Staff witness Hill estimated the current cost of equity capital for gas distribution utility operations to range from 9.0% to 9.50%. Within that range, witness Hill recognized Atmos' financial risk to be somewhat above average and recommended a rate of return of 9.375% be used for rate setting purposes.

Adversary Staff's equity return recommendation in this proceeding was based on four equity cost estimation methodologies: DCF, CAPM, Modified Earnings-Price Ratio (MEPR) and Market-to-Book Ratio (MTB). Staff witness Hill relied primarily on his DCF results, which were at the top end of the range of the average described by the other three equity cost estimation methods.

Adversary Staff witness provided several examples available from independent sources in the capital marketplace to support the reasonableness of its 9.375% cost of equity recommendation. Long-term interest rates remain near 40-year lows despite recent short-term credit tightening by the Federal Reserve. Investor services are advising their clients to expect single-digit returns from their gas distribution utility investments. Even Atmos' Chief Executive Officer, in a presentation to the American Gas Association indicated that investors could expect returns from an investment in Atmos ranging from 7.5% to 9.5%. This evidence was un-rebutted by the Company (Tr. 1312). Recent research in the field of financial economics indicates that risk premiums (the return equity investors demand above the return available from bonds) are much lower going forward than is evident from simple averages of historical data. (Hill Direct Testimony Pages 7 - 9). Finally, Adversary Staff cites, and the Commission was asked to take notice of, recent equity return awards by other regulatory bodies that support the range of equity costs recommended by Adversary Staff.

In its September 2005 Order in Docket No. 04-121-U, the Arkansas Public Service Commission found the current cost of equity range for gas distributors to be 9.2% to 10.1%, and awarded the gas distributor, Centerpoint Energy Arkla, a 9.45% cost of equity. In the June 2005 the New Hampshire Pubic Utilities Commission in Docket No. DE 04-177 set the cost of equity for the generation assets of the Public Service Company of New Hampshire at 9.63%. The recent gas distribution decision in Arkansas and the electric generation cost of equity decision in New Hampshire support the reasonableness of Adversary Staff's determination of equity capital cost rates in this proceeding.

In its rebuttal testimony, the Company cited numerous "errors" in the testimony of Adversary Staff witness Hill. While Adversary Staff admits that there were, unfortunately, omissions in the spreadsheet programming of Mr. Hill, the result of those anomalies was de minimis and had no impact on Staff's recommendations in this proceeding.

Adversary Staff recommended a range of equity capital costs from 9.0% to 9.5%. The average of the Company's DCF and CAPM results were 10.5% and 11.7%, respectively.

In considering what would be a fair return on equity for the Company, the Commission is directed by the principles set forth in Bluefield Waterworks and Improvement Co. v. Serv. Comm'n, 262 U.S. 679 (1923), and Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944). The guidelines in those cases dictate that an appropriate return should:

(1) Be commensurate with returns on investment in other enterprises having corresponding risks and uncertainties;

(2) Provide a return sufficient to cover the capital costs of the business, including service on the debt and dividends on the stock; and

(3) Provide a return sufficient to assure confidence in the financial integrity of the enterprise to maintain its credit and capital-attracting ability.

The Supreme Court has also made it clear that the setting of just and reasonable rates involves the balancing of investor and ratepayer interests (Hope, supra, at 603). This Commission has recognized that in applying these standards each case must be determined after fully and carefully considering all of the evidence and specific facts of that case. This is so despite the fact that many of the financial models, tests of these models, and refinement of these models appear on the surface to be very similar from case to case. Furthermore, this Commission has found it appropriate to exercise a considerable amount of discretion, and to apply its own expertise in determining what a fair and equitable rate of return is.

This Commission recognizes that the cost of equity is an estimate, experts are likely to disagree on the cost of equity, and a zone of reasonableness is more appropriate than a point estimate although a point estimate is necessary for purposes of setting rates. It is understood that the witnesses in this case have based their recommendations largely on historical data ending with the time of the preparation of their testimonies and exhibits. The Commission believes that it must use its expertise and judgment in adopting the cost of equity based on what it believes are reasonable expectations regarding the future course of capital costs.

In determining what return on equity is appropriate for the Company in this proceeding, it is a useful exercise to review the testimony presented by each cost of capital witness. Having done so, the Commission finds as a matter of fact that an allowed return on equity of 10.125% is reasonable and will provide the Company an opportunity under efficient management to maintain its financial position and to be able to continue to attract the capital necessary to meet its public service obligations. We note that this determination is above the top end of the range recommended by the Adversary Staff. In addition, as stated herein, evidence presented on expected returns for Atmos investors, risk premiums and recent decisions of other state agencies reflected that the Company's proposed return was overstated.

The Company raises the argument that the Commission awarded AGLC a higher return in its rate case last year than it has awarded to Atmos. (Petition, p. 10). As a preliminary matter, the Commission has the discretion, and in fact the obligation, to weigh the evidence in an individual case and determine whether a particular witness or company has supported its position adequately. The Commission's determination for Atmos' return is well within the range of evidence in this record. Moreover, as Atmos notes, the AGLC rate case it references was ultimately resolved in the context of a stipulation. It is not persuasive to select one issue out of an entire rate case resolved by stipulation, with all the give and take settlements entail, and argue that the same result is mandated in another case based on a different record.

As a final matter, Atmos charges that the Commission based its determination on the Advisory Staff's recommendation that the Company alleges looked beyond the record. The Company's premise for this assertion is that Advisory Staff "calculated Atmos' cost of equity using the Gordon Growth Model and Market-to-Book Ration methods, respectfully." (Petition, p. 12). The Company states that neither it nor the Adversary Staff used either of these methodologies. The Company's assertion is incorrect. The Advisory Staff relied in part the Gordon Growth Model, which is identical to the DCF model used by both the Company and Adversary Staff. The other method used by the Advisory Staff, the Market-to-Book ratio, was discussed by Staff witness, Mr. Hill in his direct testimony. (See Appendix D, p. 37 and Schedule 10).

G. Composite Cost of Capital

Based upon the foregoing Findings of Fact, the Commission finds that the proper weighted Cost of Capital for use in this proceeding to be 7.569623%, calculated as shown on Schedule 3 to Appendix A.

V. POLICY ISSUES THAT AFFECT THE BASE REVENUE REQUIREMENT

A. Pipeline Replacement Program ("PRP")

The Company has proposed two separate changes to the current PRP in this case. First, the Company proposed the full roll-in to base rates of the projected test year PRP revenue requirement. Thereafter, all pipeline replacement costs would be included in base rates. The PRP rider would no longer be utilized to recover only PRP costs on an incremental revenue requirement basis.

The second component of the Company's PRP proposal is that it would retain the name of the PRP rider, but essentially reconstitute it as an alternative rate plan, computing an annual surcharge or credit to be divided between the average number of bills, excluding low income senior citizens. According to the Company, this new methodology would change the annual calculation of the surcharge or credit to include all cost changes -- not just those related to pipeline replacements. According to the Company, this would ensure that the Company does not earn significantly more or less than the allowed rate of return approved in this case. The annual adjustments to base rates would be based on the Company's computation of the revenue requirement for a projected test year, beginning May 1 of each year. The test year projection would be based upon actual results from a historic period ending September 30 of each year along with pro-forma adjustments consistent with those approved in this rate case. According to the proposal, the Company would file an annual report with Commission Staff by February 1 of each year, which would be subject to audit. If the Staff has not completed its audit of the report filing by May 1, the Company could start billing the surcharge or credit subject to refund. The Company also could appeal the Commission Staff's audit results and continue to bill the disputed amounts subject to refund pending the Commission's decision on appeal.

Adversary Staff stated in its Proposed Order that it relied on the Company's $2,127,941 quantification of the total revenue requirement effect of the proposed roll-in, which the Company based on test year cost estimates. However, the Company claimed in its Rebuttal Testimony that its initial quantification was in error and provided a revised quantification of $1,274,208 (Petersen Rebuttal Testimony at Page 2). If the Company's error is to be corrected, according to Adversary Staff, it has the effect of increasing the Company's revenue requirements for the PRP issue by $853,733 ($2,127,941 minus $1,274,208) and reducing the Adversary Staff's recommended revenue requirements for the PRP issue by the same amount.

Adversary Staff went on to state in its Proposed Order that the Company addressed the interrelationship of the quantification in this proceeding with the Staff's recommended adjustments to the Company's quantifications related to the historical year ended September 30, 2004. In a September 29, 2005 decision in Docket No. 12509-U, Atmos Energy Corporation's Iron and Bare Steel Replacement Program, the Commission voted to maintain the monthly surcharge of $.87 awaiting the conclusion of the rate case in this proceeding and to delay the Staff's recommended surcharge increase to $1.28. The Adversary Staff developed its position and filed its Direct Testimony prior to the Commission's decision in Docket No. 12509-U.

Adversary Staff opposed the Company's request to modify the PRP for several reasons.

First, the roll-in to base rates has the effect of unnecessarily increasing the Company's requested base rate increase because the PRP roll-in reflects a projected test year revenue requirement while the present PRP rider reflects a historic and, thus, lower test year revenue requirement.

Second, the Company's proposal effectively would establish an alternative rate plan, without directly requesting such a plan in accordance with the statutory requirements of O.C.G.A. § 46-2-23.1. These statutory requirements include specific notice to its ratepayers and a demonstration that its proposed plan meets a litany of specific requirements.

Third, the Company's proposal would require that it annually develop a projected test year revenue requirement comparable to its filing in this proceeding and further will require that the Staff review this revenue requirement on an expedited basis each year. This would be a substantial undertaking for both the Company and the Staff, comparable to an annual rate filing in most respects. Such filings would be far more complicated and the Staff review necessarily far more involved than is the case with the present PRP.

Fourth, the use of a projected test year necessarily involves the selection and application of numerous assumptions, at least some of which the Commission could not reasonably anticipate or preemptively affirm in this proceeding. Such assumptions would not be subject to the same level of review or challenge by the Adversary Staff or interveners that presently is available under the existing base ratemaking process.

Fifth, the projections based on such assumptions would never be trued-up to actual. Such a structure could create an inherent incentive for the Company to underestimate projected revenues and overestimate projected costs each year.

Sixth, the Company's proposal is not sufficiently developed. The Company's proposal does not identify, describe, or provide the schedules and work papers that would be required to implement such a plan. At a minimum, such a plan would require an annual filing that provides the same information that is currently provided in the Commission's Minimum Filing Requirements.

The Commission finds as a matter of fact that Petersen's Rebuttal quantification of the PRP issue went further than the correction indicated by Adversary Staff which resulted in the $1,274,208 PRP quantification, to also remove PRP surcharge revenues in the amount of $673,112 which were included in the test year revenues at present rates (Petersen Rebuttal Testimony at Page 3). This then results in a revenue requirements reduction of $601,096 instead of the $1,274,208 acknowledged by Adversary Staff. (refer to Appendix A, Schedule 4c for side-by-side calculations of the PRP removal quantification).

The Commission finds as a matter of fact that, as discussed in the Rate Base Section of this Order, the projected rate base included in the Company's filing should be reduced by the amount associated with the PRP in the amount of $10,039,182, which in turn reduces test year revenue requirements by $1,270,559.

The Commission finds as a matter of fact that, as discussed in the Operating Income Section of this Order, before-tax Operating Income should be reduced by $669,463 ($409,042 after-tax), which in turn increases test year revenue requirements by $669,463 to reflect the removal of the net result of before-tax PRP-Operating Revenues in the amount of $673,112 minus before-tax PRP-Operating Expenses in the amount of $3,649.

The Commission finds as a matter of fact that the Company's proposal to reconstitute the present PRP rider into an alternative rate plan is not appropriate. In general, the Company should continue to recover its pipeline replacement costs in the same manner as it presently does as approved by this Commission in Docket No. 12509-U, which will maintain the status quo and result in no harm to the Company. However, the Commission recognizes that its September 29, 2005 decision in Docket No. 12509-U to delay implementation of the surcharge increase has not provided the Company full recovery of its pipeline replacement costs through the PRP rider. The Commission finds that the surcharge amount should be adjusted to a level that will provide full recovery to the Company because of the delay in the surcharge increase implementation. The computation of the new surcharge amount as well as the implementation date of the surcharge increase is to be decided as part of Docket No. 12509-U.

B. Gas Cost Portion of Bad Debt

The Company has proposed to include the gas cost portion of bad debt in its PGA rather than in base rates. In accordance with its proposal, the Company removed $861,523 in expense from the base revenue requirement in this proceeding. The Company justified its proposal by asserting that the Company would collect 100% of its uncollectible expense related to gas costs, no more and no less. The Company cited the recent volatility in gas prices as another justification for a change in recovery treatment. The Company referenced Georgia's Gas Supply Statute, O.C.G.A Section 46-2-26.5(7) and asserted that the statute does not preclude the gas component cost of un-collectibles from the definition of gas costs.

Adversary Staff and the Consumer Utility Counsel ("CUC") opposed the Company's request to modify its recovery of the gas portion of bad debt expense for several reasons. First, the Commission already has ruled that such costs are not "purchased gas costs" as defined in O.C.G.A. § 46-2-26.5(a)(7). In Docket No. 14105-U, the Company filed an Amendment to the 2001-2002 Gas Supply Plan and filed testimony to recover delinquencies incurred as a result of a Commission ordered moratorium on termination of service to firm customers. In that docket, the Adversary Staff filed a Motion to Strike and argued among other reasons that "the delinquencies that the Company seeks to recover represent bad debt" and that such costs were not recoverable pursuant to the PGA statute. In response to Adversary Staff's motion, the Commission struck both the Amendment and the testimony "for the reasons set forth in Adversary Staff's motion."

Second, at the time the Adversary Staff filed its Direct Testimony, the Company had not described how it would compute the actual uncollectibles expense that would be recovered through the PGA. As such, it was not clear whether the expense would be the actual write-off amounts recovered in arrears, projected write-off amounts, or an expense accrual, and if an expense accrual, on what basis it would be quantified and trued-up in future PGA filings, if at all. In its Rebuttal Testimony, the Company provided a further description of how it would implement its proposal and that it would be based on actual write-offs, net of subsequent recoveries.

CUC witness, Steven Ruback, testified that this proposal would eliminate the incentive for the Company to minimize uncollectible gas costs as all of the Company's collection risk would be shifted to ratepayers. Mr. Ruback also added that for costs to be included in the PGA, they should be direct gas costs and "beyond Atmos' control and large enough to jeopardize Atmos financial health between rate cases".

The Commission finds as a matter of fact that the Company's proposal to include the gas cost portion of bad debt in its PGA rather than in base rates should be rejected and that the amount of $861,523 excluded by the Company from the base revenue requirement should be added back in, subject to the further adjustments to bad debt expense described in this Order.

In addition to being poor policy, the Commission finds that the Company's position is inconsistent with Georgia law. The Code allows gas utilities to recover "purchased gas costs" through its purchased gas adjustment rate. "Purchased gas costs" are defined as all costs incurred by a gas utility for the purpose of acquiring gas delivered to its system in order to supply its firm customers, including without limitation, the costs incurred in purchasing gas from sellers; the costs incurred in transactions involving rights to buy and sell gas; the costs incurred in gathering gas for transportation to the gas utility; the costs incurred in transporting gas to the facilities of the gas utility; the costs incurred in acquiring and using gas storage service from others, including the costs of injecting and withdrawing gas from storage; and all charges, fees and rates incurred in connection with such purchases, rights, gathering, storage and transportation. O.C.G.A. § 46-2-26.5(a)(7).

As pointed out by both the Adversary Staff and the CUC, this definition does not include uncollectibles. While Atmos asserts that the list of costs included within the statutory definition is not exclusive, bad debt expense cannot reasonably be characterized as a cost "incurred by a gas utility for the purpose of acquiring gas delivered to its system." O.C.G.A. § 46-5-26.5(a)(7). Rather, bad debt expense is a business expense that is related to collection efforts and is not specific to either regulated Gas Distribution Companies or commodity costs.

C. Margin Loss Recovery Rider

The Company has proposed to retain the Margin Loss Recovery rider, but to reset the initial factor to $0 by rolling the current recovery amount into base rates. The rider would continue to operate as it has in the past, with incremental margin losses subsequent to the effective date of rates in this proceeding recovered through the rider and reflected in the factor.

Adversary Staff did not oppose the Company's request to roll the current Margin Loss Recovery rider amount into base rates. Mr. Ruback did not disagree with the roll-in of the current rider amount into base rates but added that the rider should be eliminated and that future recovery of margin losses be obtained only through regular base rate proceedings.

The Commission is not convinced that it is in the best interests of the Company's ratepayers that the Margin Loss Recovery rider be continued, or that the Company's request to roll the current rider amount into base rates be granted. The Commission agrees with Mr. Ruback that riders should be utilized primarily to protect the Company from volatile commodity prices and not to fix margin losses between rate cases. As such, the Commission finds as a matter of fact that the current Margin Loss Recovery rider amount should not be rolled into base rates, and that the rider should be eliminated. Future recovery of margin losses should be obtained through regular base rate proceedings.

In its Petition for Rehearing, Reconsideration and Oral Argument, the Company argued that it was denied its due process rights because the Procedural and Scheduling Order issued by this Commission did not expressly refer to the Margin Loss Recovery rider as an issue to be considered in this matter. (Petition, p. 22). In support of its argument, the Company cited *Georgia Public Service Commission, et al. v. Alltel Georgia Communications*. In that case, however, the Georgia Court of Appeals in reversing the Superior Court's finding that Alltel had been denied due process, held that the right to due process of law is, at its core, the right of notice and the opportunity to be heard. The guarantee of due process is satisfied if a party "has reasonable notice and opportunity to be heard and to present (its) claim or defense". In this matter, the Company was afforded more than adequate notice that the issue of the elimination of the Margin Loss Recovery rider would be considered by the Commission, as well as the opportunity to be heard on such issue.

First, the Commission's Second Revised Procedural and Scheduling Order, approved on July 19, 2005, included a list of issues involved in this matter, including specifically:

c) Are Atmos Energy's rates just and reasonable and do they recover more than the Company's revenue requirement?

d) For the test year period beginning June 20, 2005, if Atmos Energy's current rates are not just and reasonable, how should Atmos Energy's rates be modified so that the new rates are just and reasonable and reflect the Company's revenue requirement?

The Margin Loss Recovery rider is clearly a "rate" charged by the Company, and as such the Company was afforded adequate notice that the Commission might consider whether such rate was just and reasonable and whether such rate should be modified.

Further, the Company was given specific notice that the elimination of the Margin Loss Recovery rider would be considered by this Commission at the time Steven Ruback pre-filed his direct testimony on behalf of the Consumers' Utility Counsel Division of the Governor's Office of Consumer Affairs. In his pre-filed testimony, Mr. Ruback recommended that the Margin Loss Recovery rider be eliminated, a recommendation that is being adopted in this Order. The Company had ample opportunity to review Mr. Ruback's testimony. The Company obviously was aware of and reviewed Mr. Ruback's testimony regarding the Margin Loss Recovery rider, as counsel for the Company cross examined Mr. Ruback with respect to his recommendation that such rider be eliminated. (Transcript, p. 679). Finally, after having had the opportunity to review Mr. Ruback's testimony and subject Mr. Ruback to cross examination, the Company had an opportunity to address the issue of elimination of the Margin Loss Recovery rider in its rebuttal testimony.

D. Franchise Tax Recovery Rider

The Company requested a revision in the Franchise Tax Recovery rider to update the recovery mechanism for franchise tax payments made to local governments. The current rider is charged to customers located within the city limits of the municipality levying the tax and is part of the PGA. The current rider recovers fees through an estimation process that requires subsequent true-up adjustments. The Company's proposal would simplify the administration of the rider by assessing the franchise fee directly on a customer's actual monthly bill. Since both methods result in a pass-through of franchise fees, there is no revenue requirement effect from the change in methodology. The Company also proposed to include the additional charge as a component of the gas charges on the customer's bill.

Adversary Staff agreed with the Company's proposal with one exception, the appearance of the charge on the customer's bill. Since the tax rate is different for every local franchise territory and other State and County taxes are currently separated on the bill, Adversary Staff recommended that franchise fees be listed separately instead of being grouped with gas charges.

The Commission finds as a matter of fact that the Franchise Tax Recovery rider should be adjusted as proposed by the Company, that the rider should continue to be charged only to customers located within the city limits of the municipality levying the fee, and that the charge appear as a separate line item on each monthly bill beginning no later than January 1, 2006.

E. 60-Day Meter Reading Cycle

The Company requested a change in its Tariff Sheet No. 40, Service Regulation No. 4, Section 4.1 to allow it to change to a 60-day meter reading cycle during non-WNA months, described by the Company as June through September of each year.

Adversary Staff recommended that the Commission accept the Company's proposal to change to a 60-day meter reading cycle during non-WNA months, with the date modification of June through August, but only if the Commission recognized the related cost savings in conjunction with the adoption of Adversary Staff's recommendation to reflect a productivity savings reduction to test year operation and maintenance expense.

The Commission finds as a matter of fact that the Company should be allowed the option to change the meter reading cycles to 60 days during the non-WNA months described as June through August and finds that the savings from this change are reflected in the Adversary Staff's productivity savings adjustment subsequently addressed in this Order.

VI. REVENUE REQUIREMENT

Based upon the Commission's Findings of Fact discussed above, the Commission further finds that for the test year the Company has a revenue deficiency in the amount of $409,277, calculated and detailed as shown on Schedule 1 through 4 of Appendix A, "GPSC Decision 12/20/05". Revenue Requirement valuations "By Issue" are shown on Schedule 5 of Appendix A summing to the same $409,277. The following Table summarizes the Revenue Requirements calculation as presented on Schedule 1 of Appendix A:

Rate Base	$62,380,273
Weighted Cost of Capital	7.5696230%
Operating Income Required	$4,721,951
Operating Income Available	$4,471,869
Operating Income Deficiency	$250,083
Income Expansion Factor	0.611000
Additional Revenue Required	$409,300
PRP Rounding	-$23
Additional Revenue Required	$409,277

VII. EXPANDED REPORTING REQUIREMENTS

Adversary Staff recommended in this proceeding that the Company expand its periodic reporting to the Staff to better meet the Staff's monitoring and review needs. Adversary Staff recommended that the Company be required to file the following information in quarterly reports broken out on a monthly basis, which would provide Commission Staff the opportunity to review all aspects of the Company's financial performance, including its earned return, on a timely basis. The recommendation further detailed the information that should be provided as part of the quarterly reports which is stated below.

- Financial statements arranged by FERC account on a monthly and twelve month rolling basis that provide actual per books results with no ratemaking adjustments.

- Labor dollars incurred by department and by FERC account, separated between those labor dollars incurred directly by AEC Shared Services division, Mid-States Operating division, and Eastern Regional Office, which are allocated to Georgia, and amounts incurred directly by Georgia.

- A schedule detailing the various forms of capitalization with all monthly details provided to compute the actual weighted cost of capital for the thirteen month average period.

- Schedules detailing the various monthly rate of return components of rate base, operating income, the authorized cost of capital and the computation of the revenue requirement after ratemaking adjustments, on a twelve months ending basis. The rate base and operating income computations should reconcile the per books totals along with all ratemaking adjustments to arrive at the final results.

- A description and quantification of all monthly ratemaking adjustments based on the preceding thirteen month actual results.

- Full-time equivalent number of employees at month end for each month on a twelve month rolling basis for the Georgia division as well as each division that allocates costs to Georgia, including the Shared Services, Mid-States and Eastern Regional Office divisions.

- Number of gas units and customers arranged by tariff schedule per month along with the corresponding revenues derived on a twelve-month rolling basis.

- Monthly uncollectible accounts expense activity that includes the beginning balance of uncollectibles reserve, expense accruals, charge-offs netted with recoveries, and the ending reserve balance on a twelve month rolling basis.

- A matrix of costs similar to MFR schedule B-1.3 that reflects all Georgia assigned operating income costs along with separate computations of the Shared Services, Mid-States, Eastern Regional divisions and any other costs allocated to Georgia. The matrix, like MFR schedule B-1.3, should reflect quarterly and twelve month rolling actual results along with the computed allocations from each separate division and affiliate that roll into the total Georgia costs.

- A matrix similar to the one provided in response to STF-1-19 that lists allocation factors used by each AEC Shared Services cost center used to compute the average allocation factor to allocate costs to the Mid-States division, the Eastern Region and ultimately to Georgia. All changes to cost center allocations or the selection of the various factors during the current reporting period should be clearly noted.

- An identification of any changes to the Company's organization structure during the preceding period should be reported, including all mergers, acquisitions, dispositions in whole or in part.

The Commission finds as a matter of fact that the reporting requirements as detailed above be adopted. The Company should begin providing the requested quarterly reports reflecting results on a monthly basis no later than the period starting January 2006. The Commission also finds that the quarterly reports should be filed with Commission Staff within 30 days of each calendar quarter's end.

Atmos claims that as a result of these reporting requirements it would incur an additional cost of $221,250. (Petition, p. 21). The Company argues that it was arbitrary and capricious for the Commission to deny its right to recover these costs. *Id.* The Company's argument is misplaced. The Commission has not denied the Company recovery of these costs. Rather, the Commission has determined that the Company did not meet its burden to demonstrate that the rates approved in this docket are not just and reasonable and would not afford the Company an opportunity to earn a fair return.

A component of its proposal to modify the Pipeline Replacement Program was that Atmos would develop annually a projected test year revenue requirement. Under the terms of the Commission's order, Atmos is not be obligated to prepare such a filing, and will not incur any of the costs related to the preparation of such a filing. The Commission did not reduce the Company's revenue requirement as a result of relieving it from this substantial undertaking. Consequently, there is no need to increase the revenue requirement as a result of expanding the reporting requirements. The revenue requirement approved by the Commission reflects that the increase to the Company's expenses as a result of the expanded reporting requirements was offset by the Company not having to prepare annually a projected test year revenue requirement. This conclusion is conservative in favor of the Company. It is likely that the costs related to the development of an entire projected test year revenue requirement would equal, if not exceed, those related to the expanded reporting requirements ordered by the Commission.

VIII. CUSTOMER CLASS COST ALLOCATION

The Company is proposing to increase or decrease base rate revenues by customer class as follows:

			Company Proposed Revenues		
		Current	Proposed	Proposed	
Line		Rate	Rate	Increase or Decrease	
No.	Customer Class	Revenues	Revenues	Amount	Percent
(a)	(b)	(c)	(d)	(e)	(f)
1	Residential	$13,207,604	$16,459,840	$3,252,237	24.62%
2	General Service	$2,786,487	$3,389,382	$602,895	21.64%
3	Large Volume - Firm	$1,046,127	$985,765	($60,362)	-5.77%
4	Large Volume - Other	$2,446,975	$2,430,029	($16,945)	-0.69%
5	Total	$19,487,193	$23,265,017	$3,777,824	19.39%

In support of the proposed customer class rate increases or decreases, the Company presented a class cost of service study in Schedule THP-1, which was attached to the direct testimony of Atmos witness Thomas Petersen. While the Company's proposed revenues by customer class do not recover the customer class' allocated cost of service, the proposed revenues move closer to the cost of service as compared to current rate revenues. Although the Company revised its class cost of service study on September 1, 2005, the Company did not revise its proposed customer class revenue increases.

Both the Adversary Staff and the CUC filed testimony on customer class cost allocation issues. While the CUC did not present a revised class cost of service study, a revised class cost of service study was presented by the Adversary Staff in Exhibit JWD-4, which was attached to the direct testimony of Adversary Staff witness James Daniel. Based upon the Adversary Staff's overall revenue reduction, its revised cost of service study and other relevant factors, the Adversary Staff recommended the following customer class revenue decreases:

Line No.	Customer Class	Current Rate Revenues	Recommended Rate Revenues	Recommended Decrease Amount	Recommended Decrease Percent
(a)	(b)	(c)	(g)	(h)	(i)
1	Residential	$13,207,604	$10,651,781	($2,555,823)	-19.35%
2	General Service	$2,786,487	$2,786,487	$0	0.00%
3	Large Volume - Firm	$1,046,127	$821,127	($225,000)	-21.51%
4	Large Volume - Other	$2,446,975	$2,446,975	$0	0.00%
5	Total	$19,487,193	$16,706,370	($2,780,823)	-14.27%

A. Classification and Allocation of Mains

The largest customer class cost allocation in the case involves the proper classification of mains as demand-related or customer-related. The Company's investment in mains is approximately 45% of Atmos' total plant investment. Since demand and customer allocation factors are very different by customer class, the classification of mains has a significant impact on the class allocated cost of service.

The Company prepared a minimum system study which resulted in 69% of mains classified as customer-related and 31% classified as demand-related.

The Adversary Staff pointed out that the Company's proposed classification of mains was very different from both Atmos' classification of mains in other jurisdictions and the classification of mains by other utilities. The Adversary Staff also argued that minimum system studies or zero-intercept studies were not necessary for small gas systems such as Atmos' LDC in Georgia. The Adversary Staff recommended a per plant account classification for mains, similar to how Atmos classified all other plant accounts. Under the Adversary Staff's recommendation, mains should be classified as demand-related.

The CUC also opposed the Company's classification of mains and similarly objected to the large portion (69%) of mains classified as customer-related. The CUC recommends that 75% of mains be classified as demand-related and 25% classified as commodity-related. Like the

Adversary Staff's recommendation, none of the investment in mains would be classified customer-related.

The Commission finds as a matter of fact that Atmos' investment in mains should be classified as demand-related.

With respect to the allocation of demand costs, the Commission adopts the recommendation put forward by Mr. Ruback, and finds as a matter of fact that the Company's demand costs should be allocated using a 50% peak demand and 50% average demand in future Cost of Service studies. The Commission agrees with the contention of Mr. Ruback that distribution mains are not economically justified by the number of customers, but rather by the peak and annual utilization of the mains by customers that actually take gas.

B. Other Cost Allocation Issues

The Adversary Staff recommended several other revisions to the Company's class cost of service study. While not as significant as the mains classification issue, these issues do impact the accuracy of the class cost of service study. Two of the other cost allocation issues raised by the Adversary Staff are:

- Informational and instructional expenses, demonstrating and selling expenses and advertising expenses should also be allocated using the rate base allocation factor rather than the customer allocation factor.

- Regulatory commission expenses and outside services expenses should be allocated using the revenue allocation factor rather than the O&M (excluding gas) allocation factor.

The Commission finds as a matter of fact that these two cost allocation adjustments recommended by the Adversary Staff are appropriate.

The Adversary Staff also recommended that uncollectible accounts expenses be allocated using the rate base allocation factor. The Company proposed that such expenses be allocated to customer classes based on a customer allocation factor. The Commission notes that the amount of historical uncollectible write-offs is very similar to the Company's proposed allocation factor. As such, the Commission finds as a matter of fact that it is appropriate to allocate uncollectible accounts expenses based on a customer allocation factor.

C. Revenue Distribution

Using its proposed class cost of service study as a guide, the Company recommended significant rate increases for the Residential and General Service customer classes while also recommending revenue decreases for the two Large Volume customer classes.

Based upon its revised class cost of service study and other relevant factors, the Adversary Staff recommended comparable percent revenue reductions for the Residential and Large Volume–Firm customer classes and no change in revenue levels for the other two customer, General Service and Large Volume – Other.

The Commission finds as a matter of fact that the revenue increase of $409,277 calculated as shown in Appendix A, Schedule 1 through 4 - "GPSC Decision 12/20/05", shall be spread evenly among all classes based on base rate revenues under current rates, except that such rate increase shall not apply to Swift Textiles or Fort Benning.

D. Billing Determinants

The billing determinants used by Atmos in establishing its revenue requirements were based on the historical billing period of twelve months ended December 31, 2004. These were adjusted to reflect normal weather conditions, forecasted growth in number of customers, and forecasted use per customer for the test period, which was the twelve months ended May 31, 2006.

Adversary Staff reviewed the actual billing determinants for the historical period provided by the Company. Adversary Staff also reviewed the Company's adjustments to normalize the weather, and to reflect the forecasted number of customers and usage per customer. Adversary Staff expressed a concern regarding the Company's normalization adjustment. Specifically it expressed concern about Atmos' use of a 15-year time period for establishing normal weather patterns and the use of a 36 month time period to establish customers' heat sensitive load. However, Adversary Staff concluded that their concerns would not significantly alter the Company's forecasted billing determinants.

The Commission finds as a matter of fact that the Company's proposed billing determinants are appropriate for establishing just and reasonable rates in this proceeding. The Commission also finds as a matter of fact that its approval of the Company's billing determinants in this proceeding is not tacit approval of the underlying methods used by the Company in calculating those approved billing determinants.

E. Proposed Rates and Rate Design

The Company proposed no changes to the customer and commodity charges for the firm large volume service customer class except that the PRP surcharge and the margin loss recovery surcharges, as proposed by the Company, would be rolled into base rates. With those proposed changes, the firm large volume service customer class would receive a small decrease. The Company proposed a small increase to the commodity charge for the optional gas service rate schedule and related rate schedules to offset the decrease from its proposed rolling into base rates of the pipe replacement and the margin loss recovery surcharges.

The Company proposed increases to both the customer and commodity charges for the residential and general service classes, in the Company's opinion, to move the rates of return for these customer classes closer to the proposed overall return. The Company's calculation of the rate of returns for all rate classes was based on a cost of service with which Adversary Staff disagreed as detailed by Adversary Staff Witness Daniel. In addition, the Company allocated more revenue to the customer charge to increase the amount of its revenue to be recovered through fixed costs as shown on Staff Exhibit BM-4. Adversary Staff did not agree with the Company's proposal to allocate more of its revenue increase to the customer charge instead of the commodity charges because it unfairly allocates a higher percentage of the increase to residential and general service customers. Adversary Staff believed allocating the increase in this manner unfairly burdens smaller customers. Furthermore, based on Adversary Staff's revenue requirements as discussed above, Atmos rates will decrease.

Adversary Staff recommended its proposed revenue decrease be reflected in the commodity charges for both the Residential and Large Volume Customer classes and that the Customer Charge remains unchanged for these customer classes. The impact of rolling the margin loss rider into base rates will slightly increase the commodity charge for the General Service and Other Large Volume customer classes as shown on Staff Exhibit.BM-3. For the General Service and Other Large Volume customer classes, Adversary Staff also recommended that the customer charge remain the same.

The Commission finds as a matter of fact that it is appropriate to spread the $409,277 increase in revenue requirements evenly among all classes based on base rate revenues under current rates, except that such rate increase shall not apply to Swift Textiles or Fort Benning. Additionally, the Commission finds as a matter of fact that the Customer Charge for all customers shall remain unchanged. Finally, the Commission finds as a matter of fact that the Company shall file a compliance filing reflecting new rates within 10 days of this Order.

F. Weather Normalization Adjustment

Atmos has proposed two modifications to its existing Weather Normalization Adjustment ("WNA"), which is contained on Sheet No. 33.1 of the Company's tariff and has been in place since 1990. The first modification the Company proposes is to refresh certain variables in the WNA calculation on an annual basis. The second proposed modification is to incorporate a correction factor into the calculation.

The proposed modifications effectively decouple the Company's revenues from any impact of changes in actual volumes sold as acknowledged by Company witness Smith in his testimony in which he stated, "Yes, the correction factor will compensate for all factors affecting consumption; thus fully decoupling the link between the volume of gas sold and the utility's earnings." ([Direct Testimony Smith, page 5, line 10)

The variables the Company is proposing to refresh are the calculated base load per customer ("BL") and the heating sensitive load per customer per heating degree day ("HSF") each year. The BL factor is an estimate of an average customer's gas usage that is not sensitive to changes in the temperature. HSF factor is an estimate of an average customer's gas usage that is sensitive to variation in temperature. The correction factor would compensate all factors affecting consumption, effectively decoupling the link between the volume of gas sold and Atmos' earnings.

Adversary Staff opposed the Company's modifications to the WNA for several reasons. First, Adversary Staff believed updating the BL and the HSF would change the character of the WNA and effectively increase or decrease rates approved in the most recent rate case due to changes in patterns of customers' usage. Second, Adversary Staff argued that the proposed correction factor is effectively incorporating a decoupling device into the WNA.

Additionally, Adversary Staff argued that the purpose of the WNA is to provide the Company a degree of protection between rate cases from variations in sales due to changes in weather. Adversary Staff's position is that the Company's proposed changes to refresh the BL and HSF factors and to add a correction factor go significantly beyond the purpose of the WNA.

Adversary Staff also argued the proposed modifications to the WNA inappropriately carved out one set of factors that influences the Company's rates. Adversary Staff's position was that the purpose of rate cases is to consider factors influencing the Company's rates in a comprehensive manner and to consider them in the context of the other factors influencing rates. Other factors also change between rate cases, such as cost of equity, labor costs, number of employees, pension costs, health care costs, taxes, and many other factors.

Company witness Smith acknowledged that some costs do change over time between rate cases, as evidenced by the following exchange between Adversary Staff attorney and Company witness Smith: (Transcript page 1631, lines 8-11)

> Q. But the other fixed costs have fluctuated up or down over the past ten years, correct?
>
> A. They have moved over time, but not as a relation necessarily of our volume.

The Company also acknowledged that other costs that might fluctuate are not incorporated into the proposed WNA. In response to a question regarding the reflecting costs that might decrease, Company witness Smith stated, "You know it doesn't take so by -- so it doesn't take into account any changes in the cost of service because it is strictly in isolation dealing with the volume changes. That's all it does. It doesn't address any cost of service or changes." (Transcript page 1633, lines 6-10])

Adversary Staff believes such special treatment of a select set of factors is unwarranted. Adversary Staff noted that Atmos has not had a rate filing with this Commission in ten years. Approving the Company's request to modify the WNA could increase the time between rate cases, during which the Commission would not get to assess other factors that may have decreased costs to the Company.

In cross examination of the Company's rebuttal testimony, the concept of conservation and the interaction with supply and demand was explored. The Company believed the WNA would help align the Company's and consumers' interests in conserving energy. However, the Company acknowledged that if the WNA were approved and customers used less gas, the WNA would increase the Company's rates. (Transcript page 1642, lines 11-25])

Q. All right, now if the usage -- if the volume goes down, the company has fewer ccf or fewer therms to spread the same costs over, correct?
A. Yes.
Q. And that makes that price go up, correct?
A. Not today. You know, today right now, basically our -- because of the volumes declining the price doesn't change. Our revenues go down. And that portion of revenue that's attached to the MCF, our fixed cost recovery is bound to those MCF. So today, we are -- we are basically -- the price in respect to what you're saying, the price would stay the same, our revenues would go down. Our -- our fixed costs of operation would be under recovered. ***This mechanism is intended to correct our revenue stream for that*** -- for that difference. [emphasis added]

Effectively, conservation efforts would be negated because rates to customers for the Company's distribution service would increase.

Also, Adversary Staff recommended accepting the Company's billing determinants which included an adjustment to reflect the decreased usage per customer. (Transcript Page 1645, line 19 through page 1646, line 3])

Q. Now, the company in its initial filing included in its calculation, factors for declining customer use and its projections for remedies, correct?
A. Yes, if you're talking about the -- the billing determinants in our test year, yes, it did have a provision for declining usage to catch it up to that forward looking period.
Q. Okay, and Commission staff has not objected and as a matter of fact accepted the billing determinants, correct?
A. Yes, sir.

The Commission finds as a matter of fact that the proposed changes in the WNA are not in the public interest and should be rejected. The Commission agrees that the purpose of a WNA is to track any changes in revenues caused by the difference between normal weather as established in the Company's previous rate determination and the weather actually experienced. The Commission also finds as a matter of fact that the existing WNA has accomplished those purposes as intended. Furthermore, the proposed WNA would diminish benefits to customers of implementing conservation efforts. Finally, the Commission finds as a matter of fact that billing determinants used in establishing the Company's revenue requirement and rates incorporates an adjustment reflecting the decreased usage per customer the Company is experiencing. Therefore, the Company's proposed modifications to the WNA are rejected.

IX. TARIFF ISSUES

A. Rate Schedule 850

The Company has proposed to lower the requirements for a customer to be eligible for Rate Schedule 850. The Company proposed this change to match the volumetric requirement of its Transportation Rate Schedule 860, which is a companion tariff to Rate Schedules 850 and 830 and suggested that the proposed change will not only eliminate some confusion between the two volumetric requirements but will also offer some of its current large volume customers a lower rate option. If the volumetric requirement was lowered, there would be 19 additional customers that would qualify for Rate Schedule 850 and the annual revenue lost from the shift of these customers from Rate Schedule 830 to Rate Schedule 850 would be $77,895. This revenue shift would be absorbed by the other customer classes.

Adversary Staff recommended that the Commission deny the Company's request to lower the requirements for a customer to be eligible for Rate Schedule 850 because they do not agree that it is appropriate to allocate this revenue shift to other customer classes.

The Commission finds as a matter of fact that it is not appropriate to shift the additional revenue burden to the Company's other customer classes and that the proposed change to Rate Schedule 850 is not approved.

B. Activation Charge

The Company has proposed an activation charge of $40.00 applicable to all rate schedules and would apply to all meter turn-ons at an existing location. The activation charge would not apply to residential and commercial customers who apply for first time activation of service at a new premise. Further, the $40.00 activation charge would also not apply to customers that met the requirements for the Low-Income Senior Citizen Discount which are customers that are age 65 or older with an income of $12,000 or less per year. In addition, the Company is requesting that the $40.00 charge be applied to customers that have been disconnected for non-payment or have requested that service be disconnected on a seasonal basis.

Adversary Staff recommended that the Commission approve the Company's request to charge a $40.00 activation charge to customers that: 1) have been disconnected for non-payment, 2) requested a seasonal disconnection, and 3) have requested activation of service at an existing premise.

The Commission finds as a matter of fact that it is appropriate for the Company to assess an activation charge in the amount of $40.00 to customers that: 1) have been disconnected for non-payment, 2) requested a seasonal disconnection, and 3) have requested activation of service at an existing premise.

Further, Adversary Staff had recommended that the Company be required to clarify the language in its Tariff including each of the applicable rate schedules regarding the application of the activation charge. It should be clear that the $40.00 activation charge is not applicable to customers at a premise that has previously not had gas service or applicable to Low-Income Senior Citizens.

The Commission finds as a matter of fact that this clarification as recommended by Adversary Staff in the Company's Tariff is necessary and should be accepted.

C. Transfer of Service Charge

The Company proposed a charge of $20.00 for a premise that only requires a meter reading and not a reconnection to activate service. Currently, there is no charge for this service.

Adversary Staff recommended approval of the $20.00 transfer of service charge because there are costs involved prior to the activation of service for the Company and the customer activating service should be responsible for paying those costs.

The Commission finds as a matter of fact that it is appropriate for the Company to assess the transfer of service charge when activating service for a premise that only requires a meter reading and not a reconnection to activate service.

D. Deposit Requirement

The Company has proposed a modification to the tariff language on Sheet No. 38 to state the following:

> Amount of Deposit
> "The amount of deposit which may be required of a Customer or Applicant for the purpose of establishing service in accordance with this Service Regulation, shall not exceed two-and-one-half twelfths of the estimated charge for the service for the ensuing twelve months nor be less than $150.00;..."

Adversary Staff did not agree with the Company's proposed change to Sheet No. 38 requiring the minimum customer deposit to be $150.00 because it was in Adversary Staff's opinion in conflict with the current Commission Rules regarding customer deposits and recommended that the Commission deny the Company's proposed tariff change.

The Commission finds as a matter of fact that it is appropriate to deny the Company's proposed modification to Sheet No. 38 of its Tariff.

E. Non-Sufficient Funds Check Charge

The Company proposed to increase the NSF or Account Closed charge from $25.00 to $30.00. The $30.00 charge is reflected on 4th Revised Sheet No. 42, Section 5.3 Restoration of Service; Reconnection Charge: Return Check Charge.

Adversary Staff recommended approval of the Company's proposal to increase the NSF and Return Check charge to $30.00.

The Commission finds as a matter of fact that it is appropriate to increase the NSF and Return Check charge to $30.00.

F. Extension Policy

Atmos is proposing to modify its Mains Extension Policy as contained in Service Regulation No. 7 by incorporating a profitability model to determine how much it will invest in each project. The profitability model will be used to determine the construction free allowance, replacing the current method of calculating the construction free allowance based an estimate of the customer's annual usage.

The profitability model compares the cost to the Company of the facilities it has determined are needed to meet the customer's requirements with the margin revenues the project is anticipated to generate. Consideration is also given to other factors that influence the investment decision, such as marketing incentives that might be offered from time to time.

Adversary Staff did not raise an objection to the Company's proposed change to the mains extension policy. However, Adversary Staff raised several concerns relating to "cost input" factors and to "built-in" factors to be used by the Company in the profitability model and to certain specific proposed language in the tariff.

Adversary Staff recommended that the "cost input" factors and the "built-in" factors used in the profitability model be filed annually based on fiscal year end data for Commission approval. The updated factors could then be used in the profitability model for the following calendar year. The factors identified by the Adversary Staff included:

1. Operating & Maintenance costs
2. Labor costs
3. Corporate overhead rates
4. State-specific overhead rates
5. Debt and equity ratios
6. The average weighted cost of capital
7. Discount rate, based on the AWACC
8. The cost of debt
9. Labor benefits rates
10. Income tax rates
11. Ad valorem tax rates

Adversary Staff did object to certain language in Atmos' proposed tariff language. Specifically, Adversary Staff objected to language that permitted Atmos' to consider "other appropriate information" when considering a mains extension. Adversary Staff believed that such language provided too much discretion to the Company without providing any explanation on what the Company might consider.

The Commission finds as a matter of fact that the Company's proposed modification to the mains extension policy is in the public interest and should be approved, subject to the following exceptions. By December 1 of each year, the Company shall file with the Commission for its approval the cost factors and the input factors listed above, as well as any other information that will be used in the profitability model to determine a customer's construction free allowance. Once approved by the Commission, such updated information shall be used by the Company when considering mains extensions until such information is subsequently updated by the Company and approved by the Commission. Additionally, the Company shall remove the language "other appropriate information" from its proposed mains extension tariff provisions.

G. Other Tariff Changes

There were several changes the Company proposed to its Tariff that concerned Staff. These include: 5th Revised Sheet No. 41, Section 5.1 (a) which lowers the amount of time from the date of a bill that a residential customer may have service discontinued from forty-five (45) to thirty (30) days. This proposed Tariff change is in direct conflict with Commission Rule 515-3-3-.01(e).

Staff was also concerned with the Company's proposed Tariff changes to 4th Revised Sheet No. 10 and 3rd Revised Sheet No. 49. The proposed change on 4th Revised Sheet No. 10 requires a customer to pay for the cost and installation of measurement data collection and verification equipment. The proposed change to 3rd Revised Sheet No. 49 adds a minimum $75 charge to a customer for the testing of a meter if the meter is within three (3) percent of accurate.

These proposed Tariff changes were not addressed in the Company's Direct testimony and the Company has not provided sufficient evidence that the Tariff modifications are needed.

In the Company's Rebuttal Testimony, Company Witness Mike Ellis addressed the Company's proposed change to 4th Revised Sheet No. 10. He stated that the proposed change to 4th Revised Sheet No. 10 requires customers on Rate Schedule 850 to pay for the cost and installation of electronic data collection and measurement equipment and that Adversary Staff recommends denial simply on the basis that the Company did not provide support for this change in its testimony and that it was an oversight on Mr. Ellis' part.

Adversary Staff recommended that the Commission deny the Company's proposed changes to 5th Revised Sheet No. 41, 4th Revised Sheet No. 10 and 3rd Revised Sheet No. 49. Since review of the Company's Rebuttal testimony in which the Company addressed the proposed change to 4th Revised Sheet No. 10, Adversary Staff does agree that it is appropriate for the customer to pay for the additional metering equipment and therefore recommends approval of the Company's proposed change to 4th Revised Sheet No. 10. Adversary Staff's positions on the other two Tariff modifications remain the same as in its direct testimony.

The Commission finds as a matter of fact that the Company's proposed changes to 5th Revised Sheet No. 41 and 3rd Revised Sheet No. 49 are not justified and the Company should provide more evidence that the Tariff changes are needed. The Commission finds that the proposed change to 4th Revised Sheet No. 10 is appropriate.

X. OTHER ISSUES

The Commission also finds as a matter of fact that it is appropriate to require the Company to initiate a program to allow customers to contribute to a fund designed to assist low income senior ratepayers with payment of their natural gas bills. As such, the Company shall provide each of its customers the option to check a box on their monthly bill indicating that such customer desires to contribute an additional one dollar ($1.00) per month over and above the billed amount to be distributed to low income senior ratepayers to assist with payment of their natural gas bills. The Company shall design such program for submission to this Commission for its consideration no later than December 12, 2005. Such program shall include, but not be limited to, the following information:

- Suggested name for this program
- Proposed wording on ratepayers' monthly bills that describes how ratepayers may participate in this program and how, after participating, they may withdraw from the program
- The names of agencies/entities who will be responsible for designating individual Atmos' low income senior ratepayers to receive assistance under this program and in what specific amounts
- A description, and the estimated level, of any administrative costs incurred by Atmos in the creation and administration of this program. Such costs would be deducted from the amounts collected under this voluntary program and would be reimbursed in no other way
- Any other information germane to the creation and operation of such a program

XI. SUMMARY OF FINDINGS OF FACT/CONCLUSIONS OF LAW

The Commission provides the following as a summary of its findings of fact and conclusions of law in this Order:

1. The Commission finds as a matter of fact and a conclusion of law that the appropriate test year is the twelve-month period ending June 19, 2006.

2. The Commission finds and concludes that the Company must implement an increase in rates to result in a revenue increase in the amount of $409,277.

3. The Commission finds as a matter of fact that the revenue requirement should be reduced by $1,270,559 to reflect the removal of rate base components of the Pipeline Replacement Program.

4. The Commission finds as a matter of fact that the revenue requirement should be reduced by $137,854 to reflect the setting of the cash working capital component of rate base to zero dollars. The Commission further finds that a more accurate calculation of Cash Working Capital is by use of a Lead – Lag study, rather than a ratio of test year expenses.

5. The Commission finds as a matter of fact that the revenue requirement should be reduced by $372,416 to reflect Accumulated Deferred Income Tax (ADIT) adjustments related to correction of the ADIT Composite Income Tax Rate to conform to Georgia's composite tax rate ($30,166) and correction for ADIT errors ($342,250).

6. The Commission finds as a matter of fact that the revenue requirement should be increased by $79,382 for an adjustment to Accumulated Depreciation Reserve included in test year rate base reflecting the Commissions finding that test year Depreciation Expense should be reduced. The Commission further finds that because of the lower test year depreciation expenses the Accumulated Deferred Income Taxes included in rate base should also be adjusted resulting in a reduction to test year revenue requirement of $30,879.

7. The Commission finds as a matter of fact that the revenue requirement should be reduced by $7,319 to reflect the inclusion of the Georgia portion of Injuries and Damages Reserve in rate base.

8. The Commission finds as a matter of fact that the revenue requirement should <u>not be adjusted</u> for Adversary Staff's proposed reduction to test year rate base reflecting proposed adjustments and corrections to the Weighted Composite Factor for allocation of expenses to the Georgia division.

9. The Commission finds as a matter of fact that the revenue requirement should not be reduced as proposed by Adversary Staff for adjustments to test year Depreciation Expense, Operations and Maintenance Expenses and Other Taxes to reflect revisions and corrections to the Composite Factor utilized to allocate Shared Services expenses.

10. The Commission finds as a matter of fact that the revenue requirement should be reduced by $1,254,473 to reflect modification of Depreciation Rates for the Georgia Division ($751,638) and for Shared Services ($502,835).

11. The Commission finds as a matter of fact that the revenue requirement should be reduced by $368,137 resulting from adjustments to escalation factors to reflect productivity gains in Operations and Maintenance Expenses ($355,890) and a companion adjustment to Other Tax Expense ($12,247).

12. The Commission finds as a matter of fact that the revenue requirement should not be reduced by Adversary Staff's proposed adjustment in the amount of $156,945 to reflect excessive charges from Atmos Energy Services included by the Company in test year expenses. The Commission finds that such charges were not excessive and that they are therefore appropriately included by the Company in its Cost of Service.

13. The Commission finds as a matter of fact that the revenue requirement should be increased by $861,523 to add back to test year Bad Debt expenses the portion of bad debt the Company attributed to natural gas uncollectible expenses.

14. The Commission finds as a matter of fact that the revenue requirement should be reduced by $119,000 to reflect annual economic benefit resulting from the research and development expenditure.

15. The Commission finds as a matter of fact that the revenue requirement should be reduced by $40,000 to reflect the amortization of Rate Case Expenses over five (5) years rather than three (3) years.

16. The Commission finds as a matter of fact that the revenue requirement should be reduced by $81,504 for reduced income tax expense reflecting the amortization of Investment Tax Credit attributable to United Cities Gas Company.

17. The Commission finds as a matter of fact that the revenue requirement should be reduced by $27,700 to reflect savings resulting from the consolidation of the President's position at the Company's Mid-South Division.

18. The Commission finds as a matter of fact that the revenue requirement should be reduced by $319,511 to reflect the adjustment to Uncollectible Account Expense which sets Test Year Uncollectible Expense at $750,000.

19. The Commission finds as a matter of fact that the revenue requirement should be increased by $669,463 to reflect the removal of the operating income components of the Pipeline Replacement Program (PRP) from base rates. This amount results from the net effect of subtracting $3,649 in PRP Operating Expenses from $673,112 in PRP Operating Revenues.

20. The Commission finds as a matter of fact that the revenue requirement should be increased by $2,456 to reflect additional Uncollectible Account Expense associated with the incremental revenue increase determined in this case, $409,277 as discussed above, calculated through application of a 0.6% Uncollectible Expense Ratio.

21. The Commission finds as a matter of fact that the proper Capital Structure for the test year consists of 45% Common Equity, 50% Long-term Debt and 5% Short-term Debt.

22. The Commission finds as a matter of fact the proper cost of test year Short-term Debt to be 4.74% and that inclusion of Short-term Debt in the Company's Capital Structure at this cost results in a $465,230 reduction to the test year revenue requirement.

23. The Commission finds as a matter of fact the proper cost of Long-term Debt to be 5.5527451% and that inclusion of Long-term Debt in the Company's Capital Structure at this cost results in a $36,572 reduction to the test year revenue requirement.

24. The Commission finds that the appropriate cost of Common Equity to the Company for the test year is 10.125%. and that inclusion of Common Equity in the Company's Capital Structure at this cost results in a $861,430 reduction to the test year revenue requirement.

25. The Commission finds that the overall return allowable for the test year is 7.5696230%.

26. The Commission finds as a matter of fact that the current Margin Loss Recovery rider amount should not be rolled into base rates, and that the rider should be eliminated. Future recovery of margin losses should be obtained through regular base rate proceedings.

27. The Commission finds as a matter of fact that the Franchise Tax Recovery rider should continue to be charged only to customers located within the city limits of the municipality levying the fee, and that the charge appear as a separate line item on each monthly bill beginning no later than January 1, 2006.

28. The Commission finds as a matter of fact that the Company shall be allowed the option to change the meter reading cycles to 60 days during the months that the Company's Weather Normalization Adjustment is not applicable, June through August.

29. The Commission finds as a matter of fact that the additional periodic reporting as described in Section VII above shall be instituted with quarterly reporting to commence for the period beginning January 2006.

30. The Commission finds as a matter of fact that Atmos' investment in mains should be classified as demand-related. With respect to the allocation of demand costs, the Commission adopts the recommendation put forward by Mr. Ruback, and finds as a matter of fact that the Company's demand costs should be allocated using a 50% peak demand and 50% average demand in future Cost of Service studies.

31. The Commission finds as a matter of fact that informational and instructional expenses, demonstrating and selling expenses and advertising expenses should be allocated using the rate base allocation factor rather than the customer allocation factor.

32. The Commission finds as a matter of fact that it is appropriate to allocate uncollectible accounts expenses based on a customer allocation factor.

33. The Commission finds as a matter of fact that regulatory commission expenses and outside services expenses should be allocated using the revenue allocation factor rather than the O&M (excluding gas) allocation factor.

34. The Commission finds as a matter of fact that the proposal of the Company to recalculate, or refresh, annually the Weather Normalization variables, the base load per customer ("BL") and the heating sensitive load per customer per heating degree day ("HSF") is denied.

35. The Commission finds as a matter of fact that the Correction Factor to the Weather Normalization Adjustment is denied.

36. The Commission finds as a matter of fact that the volumetric requirements of the Company's Rate Schedule 850 shall remain unchanged.

37. The Commission finds as a matter of fact that the revenue increase of $409,277 discussed above shall be spread evenly among all classes based on base rate revenues under current rates, except that such rate increase shall not apply to Swift Textiles or Fort Benning.

38. The Commission finds as a matter of fact that the Customer Charge for all customers shall remain unchanged.

39. The Commission finds as a matter of that the Company shall file a compliance filing reflecting new rates within 10 days of this Order.

40. The Commission finds as a matter of fact that the Company's proposed modification to the mains extension policy is in the public interest and should be approved, subject to the exceptions described in Section IX.F above.

41. The Commission finds as a matter of fact that the PRP Surcharge modification proposed by the Company is denied and the PRP rider shall continue as provided in Docket No. 12509-U.

42. The Commission finds as a matter of fact that the present PRP rider shall be revised in order to allow full recovery of any under-collected amounts stemming from the Commission's September 29, 2005 decision in Docket No. 12509-U.

43. The Commission finds as a matter of fact that it is appropriate for the Company to assess an activation charge in the amount of $40.00 to customers that: 1) have been disconnected for non-payment, 2) requested a seasonal disconnection, and 3) have requested activation of service at an existing premise. The Commission finds as a matter of fact that the clarification recommended by Adversary Staff in the Company's Tariff so as to clarify that the $40.00 activation charge is not applicable to customers at a premise that has previously not had gas service or applicable to Low-Income Senior Citizens is necessary and should be accepted.

44. The Commission finds as a matter of fact that the Company shall assess a Transfer Fee of $20.00 for the activation of service to a premise that only requires a meter reading and not a reconnection to activate service

45. The Commission finds as a matter of fact the Company's request to a deposit for service of not less than $150.00 is contrary to provisions of the Utility Rules of the Georgia Public Service Commission and is denied.

46. The Commission finds as a matter of fact that it is appropriate for the Company to increase the Non-Sufficient Funds and Returned Check Charge to $30.00.

47. The Commission finds as a matter of fact that the Company's proposal to amend its Rules and Tariffs such that the disconnection date for customer service is reduced from 45 to 30 days from the date of the bill is contrary to the Utility Rules of the Georgia Public Service Commission and is denied.

48. The Commission finds as a matter of fact that the Company's proposal to amend the provisions of Rate Schedule 850 to require customers to pay for the cost and installation of electronic data collection and measuring equipment is approved.

49. The Commission finds as a matter of fact that the Company's proposal to amend its Tariffs to provide for a $75.00 meter testing charge is denied.

ORDERING PARAGRAPHS

After consideration of all of the evidence presented in this proceeding and upon the Commission's findings of fact and conclusions of law, the Commission adopts and sets out the ordering paragraphs below.

WHEREFORE, it is

ORDERED, that Atmos Energy Corporation is ordered to increase rates to produce an increase in revenues in the amount of $409,277, determined and calculated as described in the body of this Order and in Appendix A, Schedules 1 through 4, "GPSC Decision 12/20/05", with said rates to be effective for service rendered on and after November 22, 2005.

ORDERED FURTHER, that the tariffs implemented by the Company to collect the aforesaid increased revenues of approximately $409,277 shall be subject to review by the Commission to insure that such tariffs as implemented are proper and just.

ORDERED FURTHER, that the appropriate test year for this proceeding is the 12 months ending June 19, 2006.

ORDERED FURTHER, that the Depreciation Rates shall be set in conformance with the Commission's Findings of Fact in this Order.

ORDERED FURTHER, that in future rate proceedings the Company shall determine the cash working capital component of rate base by use of the lead-lag study methodology.

ORDERED FURTHER, that the appropriate test year Capital Structure is comprised of 45% Common Equity, 50% Long-Term Debt and 5% Short-term Debt

ORDERED FURTHER, that for the test year the cost of Long-term Debt is 5.5527451% the cost of Short-term Debt is 4.74%, the cost of Common Equity is 10.125% and the overall weighted cost of capital is.7.5696230%.

ORDERED FURTHER, that the Pipeline Replacement Program Rider will continue in operation as provide in Docket No. 12509-U.

ORDERED FURTHER, that Company's proposal to reconstitute the present PRP rider into an alternative rate plan is hereby denied

ORDERED FURTHER, that the Company's proposal to include the gas cost portion of bad debt in its PGA rather than in base rates is hereby rejected.

ORDERED FURTHER, that the Commission Staff shall initiate a proceeding under Docket No. 12509-U to determine Pipeline Replacement Program rider true-up and resetting.

ORDERED FURTHER, that the current Margin Loss Recovery rider amount shall not be rolled into base rates, and that the rider should be eliminated. Future recovery of margin losses should be obtained through regular base rate proceedings.

ORDERED FURTHER, that the Franchise Tax Recovery rider shall be adjusted as proposed by the Company, that the rider shall continue to be charged only to customers located within the city limits of the municipality levying the fee, and that the charge shall appear as a separate line item on each monthly bill beginning no later than January 1, 2006.

ORDERED FURTHER, that the Company shall be allowed the option to change the meter reading cycles to 60 days during the months that the Company's Weather Normalization Adjustment is not applicable.

ORDERED FURTHER, that the reporting requirements proposed by the Adversary Staff are hereby adopted. The Company shall begin providing the requested quarterly reports reflecting results on a monthly basis no later than the period starting January 2006. The quarterly reports shall be filed with Commission Staff within 30 days of each calendar quarter's end.

ORDERED FURTHER, that the Company's investment in mains shall be classified as demand-related. With respect to the allocation of demand costs, the Commission finds as a matter of fact that the Company's demand costs shall be allocated using a 50% peak demand and 50% average demand in future Cost of Service studies.

ORDERED FURTHER, that the informational and instructional expenses, demonstrating and selling expenses and advertising expenses shall be allocated using the rate base allocation factor rather than the customer allocation factor.

ORDERED FURTHER, that the regulatory commission expenses and outside services expenses shall be allocated using the revenue allocation factor rather than the O&M (excluding gas) allocation factor.

ORDERED FURTHER, that the Company shall allocate uncollectible accounts expenses based on a customer allocation factor.

ORDERED FURTHER, that the Company's proposed billing determinants are appropriate for establishing just and reasonable rates in this proceeding. The Commission also finds as a matter of fact that its approval of the Company's billing determinants in this proceeding is not tacit approval of the underlying methods used by the Company in calculating those approved billing determinants.

ORDERED FURTHER, that there shall be no change in the methodology used by the Company for the calculation and application of the Weather Normalization Adjustment Factor.

ORDERED FURTHER, that the revenue increase of $409,277 shall be allocated evenly among all classes based on base rate revenues under current rates, except that such rate increase shall not apply to Swift Textiles or Fort Benning.

ORDERED FURTHER, that the Customer Charge for all customers shall remain unchanged.

ORDERED FURTHER, that the Company's proposed modification to the mains extension policy is in the public interest and is hereby approved, subject to the following exceptions. By December 1 of each year, the Company shall file with the Commission for its approval the cost factors and the input factors utilized, as well as any other information that will be used in the profitability model to determine a customer's construction free allowance. Once approved by the Commission, such updated information shall be used by the Company when considering main extensions until such information is subsequently updated by the Company and approved by the Commission. Additionally, the Company shall remove the language "other appropriate information" from its proposed main extension tariff provisions.

ORDERED FURTHER, that that it is appropriate for the Company to assess an activation charge in the amount of $40.00 to customers that: 1) have been disconnected for non-payment, 2) requested a seasonal disconnection, and 3) have requested activation of service at an existing premise. The Commission finds as a matter of fact that the clarification recommended by Adversary Staff in the Company's Tariff so as to clarify that the $40.00 activation charge is not applicable to customers at a premise that has previously not had gas service or applicable to Low-Income Senior Citizens is necessary and is hereby accepted.

ORDERED FURTHER, that for premises that only require a meter reading and not a reconnection to activate service Company shall set and assess a Transfer Fee of $20.00 for the activation of service.

ORDERED FURTHER, that the Company's requirements for customer deposit for the initiation of service shall remain unchanged.

ORDERED FURTHER, that the Company shall set and assess a fee for Non-sufficient Funds and Returned Check Charge of $30.00.

ORDERED FURTHER, that the Company's notice of disconnection provisions service shall remain unchanged, and the Company's proposed changes to 5th Revised Sheet No. 41 and 3rd Revised Sheet No. 49 are not justified and are hereby denied. The Commission further finds that the proposed change to 4th Revised Sheet No. 10 is appropriate and is hereby granted

ORDERED FURTHER, that the Company shall amend Rate Schedule 850 so as to require customers to bear the cost and installation of electronic data collection and measuring equipment.

ORDERED FURTHER, that the volumetric requirements for customer eligibility for Rate Schedule 850 shall remain unchanged.

ORDERED FURTHER that the Company's Tariff shall not be amended so as to require a fee of $75.00 meter testing charge.

ORDERED FURTHER, that the Company is hereby required to initiate a program to allow customers to contribute to a fund designed to assist low income senior ratepayers with payment of their natural gas bills. The Company shall provide each of its customers the option to check a box on their monthly bill indicating that such customer desires to contribute an additional one dollar ($1.00) per month over and above the billed amount to be distributed to low income senior ratepayers to assist with payment of their natural gas bills. The Company shall design such program for submission to this Commission for its consideration no later than December 12, 2005. Such program shall include, but not be limited to, the following information:

- Suggested name for this program.
- Proposed wording on ratepayers' monthly bills that describes how ratepayers may participate in this program and how, after participating, they may withdraw from the program.
- The names of agencies/entities who will be responsible for designating individual Atmos' low income senior ratepayers to receive assistance under this program and in what specific amounts.
- A description, and the estimated level, of any administrative costs incurred by Atmos in the creation and administration of this program. Such costs would be deducted from the amounts collected under this voluntary program and would be reimbursed in no other way.
- Any other information germane to the creation and operation of such a program.

ORDERED FURTHER, that any request made by Atmos Energy Corporation that is not expressly granted in this order shall be deemed to be denied in its entirety.

ORDERED FURTHER, that no later than ten (10) days after this Order, Atmos Energy Corporation shall file revised Rules, Rates and Tariffs in conformance with the Commission Findings presented herein.

ORDERED FURTHER, that all findings, conclusions and decisions contained within the preceding sections of this Order are adopted as findings of fact, conclusions of law, and decisions of regulatory policy of this Commission.

ORDERED FURTHER, that jurisdiction over this proceeding is expressly retained for the purpose of entering such further order or orders as this Commission may deem proper.

ORDERED FURTHER, any motion for reconsideration, rehearing, or oral argument shall not stay the effectiveness of this order unless expressly ordered by the Commission.

The above by action of the Commission in Administrative Session on the 20th day of December 2005.

Reece McAlister
Executive Secretary

Date

Stan Wise
Chairman

Date

CERTIFICATE OF SERVICE

DOCKET NO. 20298-U

IN RE: ATMOS ENERGY CORPORATION'S AFFILIATE TRANSACTION AUDIT REVIEW / 2005 RATE CASE

I, the undersigned, do herewith certify that I have caused to be served the required copies of the enclosed Order on Reconsideration and Final Order to Atmos Energy Corporation and all other parties to the case as listed below by first class mail with proper postage affixed, unless otherwise indicated, as follows:

Reece McAlister*
Executive Secretary
Georgia Public Service Commission
244 Washington Street, SW
Atlanta, GA 30334

Tom Bond*
Director of Utilities
Georgia Public Service Commission
244 Washington Street, SW
Atlanta, GA 30334

Christiane L. Sommer, Director *
Consumers' Utility Counsel Division
Governor's Office of Consumer Affairs
2 Martin Luther King, Jr. Drive
Suite 356, East Tower
Atlanta, GA 30334

Julius M. Hulsey
Hulsey, Oliver & Mahar
Post Office Box 1457
Gainseville, GA 30503

Patricia Childers
Vice President, State Regulatory Affairs
Atmos Energy Corporation
810 Crescent Centre Drive, Suite 600
Franklin, TN 37067-6226

Misty S. Kelly
Baker, Donelson, Bearman, Caldwell & Berkowitz, PC
1800 Republic Centre
633 Chestnut Street
Chattanooga, TN 37450-1800

* By Hand Delivery or Email

Respectfully submitted, this ____ day of ________________, 2006

____

Quawanda Boyer
Administrative Assistant

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, JANUARY 7, 2005

APPLICATION OF

ATMOS ENERGY CORPORATION CASE NO. PUE-2003-00507

For an increase in rates

FINAL ORDER

On February 27, 2004, Atmos Energy Corporation ("Atmos" or the "Company") filed a rate application, supporting testimony, and exhibits with the State Corporation Commission ("Commission") for an increase in rates. Atmos' application sought to increase the Company's annual revenues by $949,111, an increase of approximately 2.13% in overall revenues. The Company filed financial and operating data for the twelve months ended September 30, 2003 ("test year"), in support of its application. The Company's proposed $949,111 increase to annual revenues was based in part upon a proposal to increase Atmos' authorized return on common equity from 11% to 12%.

The Company's February 27, 2004, application proposed to initiate a Weather Normalization Adjustment ("WNA") to protect the Company and its customers from unanticipated fluctuations in gas margins due to weather changes. The Company also proposed changes to its Purchased Gas Adjustment ("PGA") rider (as noted in the attached Stipulation) to (a) include interest on the Actual Gas Cost Adjustment ("ACA") balances; (b) include within the ACA the cost of gas for uncollectible accounts written off by the Company; (c) permit the Company to project billing determinants, sales volumes, and supplier rates in its PGA computations; and (d) remove the credit for Company use from the ACA.

On March 24, 2004, the Commission entered its Order for Notice and Hearing. In that Order, the Commission docketed the application, suspended the Company's proposed rates for a period of 150 days to and through July 26, 2004; appointed a Hearing Examiner to the case; set the case for hearing on October 26, 2004, before a Hearing Examiner; established a procedural schedule for the filing of testimony by the Company, Staff, and respondents; and provided for the participation of public witnesses. The March 24, 2004, Order for Notice and Hearing prescribed the notice for the Company's application to be published throughout the Company's service territories within the Commonwealth of Virginia and provided for the service of the Order on local officials in the city, counties, and towns in Virginia in which the Company provides service.

On August 11, 2004, the Company filed certain revisions to its accounting adjustments and supporting schedules to its application, together with additional testimony and a Motion to Amend its application.

On August 12, 2004, the Hearing Examiner granted the Company's Motion to Amend its application.

On October 19, 2004, the Company, by counsel, filed a Motion to suspend the date for filing the Company's rebuttal testimony and to limit the October 26, 2004, hearing to the presentation of the testimony of public witnesses.

On October 21, 2004, the Hearing Examiner entered a Ruling that suspended the filing date for Atmos' rebuttal testimony and provided that the October 26, 2004, hearing would be convened for the sole purpose of receiving testimony from public witnesses.

On October 26, 2004, the matter was heard by Howard P. Anderson, Jr., Hearing Examiner. Counsel appearing included Richard D. Gary, Esquire, and D. Zachary Grabill, Esquire, counsel for the Company; C. Meade Browder, Jr., Senior Assistant Attorney General, and D. Mathias Roussy, Jr., Assistant Attorney General, counsel for the Division of Consumer Counsel, Office of the Attorney General ("AG"); and Robert M. Gillespie, Esquire, and Sherry H. Bridewell, Esquire, counsel for the Commission Staff. During the October 26, 2004, hearing, proof of the Company's notice and service were received into the record as Exhibit 1. No public witnesses appeared. At the conclusion of the hearing, the case was continued generally.

On October 29, 2004, the Hearing Examiner entered a Ruling, wherein he noted that the case participants had reached an agreement concerning the issues in controversy and desired to schedule the case for hearing. The Hearing Examiner directed that a hearing on the application be reconvened at 10:00 a.m. on November 4, 2004, in the Commission's second floor courtroom.

On November 4, 2004, the case was reconvened before the Hearing Examiner. Counsel appearing included Richard D. Gary, Esquire, and D. Zachary Grabill, Esquire, counsel for the Company; C. Meade Browder, Jr., Senior Assistant Attorney General, and D. Mathias Roussy, Jr., Assistant Attorney General, counsel for the AG; and Robert M. Gillespie, Esquire, and Sherry H. Bridewell, Esquire, counsel for the Commission Staff. By agreement of counsel, the respective prefiled testimonies of the Company, Staff, and AG were identified and received into the record as exhibits in the case without cross-examination and without the witnesses taking the stand. A Stipulation, identified as Exhibit 20, purporting to resolve all of the issues in the proceeding was received into evidence. The case participants waived the right to file comments to the Hearing Examiner's Report in the event that the Hearing Examiner recommended that the Commission accept the Stipulation received into evidence in the proceeding.

On December 16, 2004, the Report of Howard P. Anderson, Jr., Hearing Examiner ("Examiner's Report") was issued. The Examiner's Report discusses the features of the Stipulation that was submitted by the parties and recommends its adoption. The Examiner noted that the parties and Staff have agreed to waive the right to file comments responsive to his Report.

As the Hearing Examiner noted, the Stipulation results in an increase in annual revenue of $371,735, based upon an authorized Return on Equity ("ROE") range from 9.5% to 10.5%, with a midpoint of 10.0% used for the designing of rates. For purposes of the Company's future earnings tests, Staff and the parties agree that a 10.0% ROE benchmark will be used for determining overearnings and will continue to be used until there is a change in the authorized ROE range.

The Stipulation also contains an agreement by the Company not to file an application for an increase in rates prior to July 1, 2006, except under emergency conditions as set out in § 56-245 of the Code of Virginia. The Report recommends adoption of this rate increase moratorium, and we concur.

As outlined in the Stipulation, the Staff and parties agreed to a WNA similar to the one adopted by the Commission for Roanoke Gas Company in Case No. PUE-2002-00373. As with Roanoke Gas, the proposed WNA protects customer bills and company revenues from the drastic changes that result from the volatility of gas prices during extremely cold weather. The Examiner's Report recommends adoption of the proposed WNA described in the Stipulation, and we concur.

The Stipulation provides for a revenue requirement of $53,500 for the cost of services that an affiliate, Atmos Energy Services ("AES"), furnishes to Atmos. When the Commission approved the affiliate arrangement between Atmos and AES, it stated: ". . . Atmos should bear the burden of proving, in any rate proceeding, that no market exists for the energy administrative services obtained from AES or, if a market exists, that Atmos is paying AES the lower of cost or market." See, Joint Application of Atmos Energy Corporation and Atmos Energy Services, LLC, For authority to enter into a services agreement pursuant to Chapter 4 of Title 56 of the Code of Virginia, Case No. PUE-2004-00016, Order Granting Authority at 4, April 28, 2004. The Staff and parties recognized that there has not yet been sufficient examination of the market availability and costs for the services furnished by AES but agreed that the designated amount was appropriate for this rate proceeding. Atmos agreed to fund a study, based upon 2004 information, to review the costs and market availability of such services. Such study will be filed with Staff and Consumer Counsel around mid-year 2005. Staff and Consumer Counsel have reserved the right to challenge the results of such a study and to submit additional evidence regarding the issues in the study, but no challenge can affect retroactively the rates determined in this proceeding. We agree that the amount of $53,500 is appropriate for services furnished to Atmos by AES for purposes of determining Atmos' overall revenue requirement in this case. In future rate proceedings, these costs will be reevaluated based upon the study to be submitted by Atmos and any other pertinent evidence. Atmos must prove the reasonableness of the entire amount. No presumption will be accorded the figure used in this case.

Other matters covered by the Stipulation and discussed in the Examiner's Report include Atmos' four proposed changes to its PGA rider; the use of bi-monthly meter readings; imposing no fee for hand delivering a door tag containing a notice of disconnect for nonpayment; implementation of a $40 charge for account activation or reconnection; implementing a procedure for "soft close;" providing that the Company will submit a "soft close" operating and maintenance procedure to the Division of Utility and Railroad Safety; continued funding for the Gas Technology Institute by means of base-rate recovery as of January 1, 2005, rather than the PGA mechanism, which expires at the end of 2004; and amending Atmos' criteria for customers to qualify for transportation service. The Commission agrees with the Examiner's Report on each of these matters and adopts the Stipulation in its entirety. The terms of the Stipulation are incorporated into the Order by attachment hereto.

Upon consideration of the Examiner's Report and the foregoing discussion of issues, the Commission finds as follows:

1. The use of a test year ending September 30, 2003, is proper in this proceeding;

2. Atmos' test year operating revenues, after all adjustments, were $44,084,281;

3. The Company's test year operating deductions, after all adjustments, were $41,719,260;

4. The Company's current rates produce a return on adjusted rate base of 7.66%;

5. A reasonable return on equity for the Company is in the range of 9.50% to 10.50%, and the midpoint of 10.00% shall be used to calculate rates;

6. The Company's adjusted test year rate base is $30,671,821;

7. The Company requires an additional $371,735 in gross annual revenues to earn a return on rate base of 8.41% and a return on common equity of 10.00%;

8. The Company shall refund with interest excess revenues collected under interim rates;

9. The Stipulation agreed upon by Staff and the parties is reasonable and is adopted; and

10. A WNA, as set forth in the Stipulation, is adopted in this proceeding.

Accordingly, IT IS ORDERED THAT:

(1) The Company's application for a general increase in rates is granted to the extent found above and is otherwise denied.

(2) Pursuant to § 56-238 of the Code of Virginia, the rates, charges, and tariff provisions found just and reasonable above are fixed and substituted for the rates, charges, terms, and conditions which took effect on an interim basis, subject to refund with interest, on July 27, 2004.

(3) The Company shall submit to the Commission's Division of Energy Regulation revised tariff sheets incorporating the stipulated rates, charges, terms, and conditions in accordance with the provisions of this Order and the Stipulation attached hereto.

(4) Atmos shall forthwith submit revised "soft close" operating and maintenance procedures to the Division of Utility and Railroad Safety.

(5) The Company shall use the rates and charges prescribed in Ordering Paragraph (2) to recalculate all bills rendered which were calculated using, in whole or in part, the rates and charges which took effect on July 27, 2004. Where application of the rates prescribed by this Order results in a reduced bill, the difference in all bills shall be refunded with interest within ninety (90) days of the entry of this Order, as directed in the Ordering Paragraphs below.

(6) The refunds with interest directed in Ordering Paragraph (5) for current customers may be made by a credit to the customers' accounts and shown on bills. The bills shall show the refunds as a separate item or items. For former customers, refunds with interest which exceed $1.00 shall be made by check mailed to the last known address of such customers. The Company may set off the credit or refund against any undisputed outstanding balance. No setoff shall be permitted against any disputed portion of an outstanding balance.

(7) The Company shall maintain a record of former customers due a refund of $1.00 or less and shall promptly make the refund by check upon request. For any refunds not paid or claimed, the Company shall comply with § 55-210.6:2 of the Code of Virginia.

(8) The refund amounts calculated as directed in Ordering Paragraph (5) shall bear interest at a rate for each calendar quarter, which shall be the arithmetic mean, to the nearest one-hundredth of one percent of the "Bank prime loan" values published in Federal Reserve Statistical Release H.15 (519), *Selected Interest Rates*, for the three months of the preceding calendar quarter. The interest shall be computed from the date payments were due as shown on bills to the date of the bill showing the credit to current customers or the date of the refund check mailed to former customers.

(9) On or before June 1, 2005, the Company shall submit to the Divisions of Public Utility Accounting and Energy Regulation a report showing that all refunds have been made pursuant to this Order and listing the expenses of refunding and the accounts charged.

(10) The Company shall not recover the interest paid or the expenses incurred to make refunds in rates and charges subject to the Commission's jurisdiction.

(11) There being nothing further to come before the Commission, this matter is dismissed, and the record developed herein shall be placed in the file for ended causes.

AN ATTESTED COPY hereof shall be sent by the Clerk of the Commission to: Richard D. Gary, Esquire, and D. Zachary Grabill, Esquire, Hunton & Williams LLP, Riverfront Plaza, East Tower, 951 East Byrd Street, Richmond, Virginia 23219-4074; C. Meade Browder, Jr., Senior Assistant Attorney General, and D. Mathias Roussy, Jr., Assistant Attorney General, Division of Consumer Counsel, Office of Attorney General, 900 East Main Street, Second Floor, Richmond, Virginia 23219; and the Commission's Office of General Counsel and

Divisions of Public Utility Accounting, Energy Regulation, Utility and Railroad Safety, and Economics and Finance.

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

APPLICATION OF	)	
	)	
ATMOS ENERGY CORPORATION	)	**Case No. PUE-2003-00507**
	)	
	)	
For an increase in rates	)	

STIPULATION

This Stipulation represents the agreement between Atmos Energy Corporation ("Atmos" or "Company"), the Applicant in this general rate case, the Staff of the State Corporation Commission ("Staff") and the Office of the Attorney General's Division of Consumer Counsel ("Consumer Counsel") (collectively, "Stipulating Participants"), by counsel, on the application of Atmos for an increase in rates. The Stipulating Participants hereby agree as follows:

1. Atmos' Application, Amended Application and all of its pre-filed direct testimony and accompanying exhibits shall be made a part of the record without cross-examination.

2. The Staff's and the Consumer Counsel's direct testimony and exhibits shall be made a part of the record without cross-examination.

3. The Stipulating Participants agree that the revenue requirement shall be based on an authorized Return on Equity ("ROE") range of 9.5% to 10.5%. The Stipulating Participants agree further that for purposes of designing rates, an ROE of 10.0% shall be used.

4. The Stipulating Participants agree that, for purposes of the Company's future earnings tests, a 10.0% ROE benchmark will be utilized for determining overearnings and such benchmark shall continue until there is a change in the authorized ROE range.

5. The Stipulating Participants agree to an updated short-term debt rate of 1.537% and an updated cost of Atmos' long term debt from 7.167% to 7.412% to reflect updated lines of credit fees.

6. For purposes of this Stipulation, the Stipulating Participants agree, there has not been sufficient examination of the market availability and costs for the services provided in the aggregate to Atmos by Atmos Energy Services ("AES"). The Stipulating Participants agree that a revenue requirement of $53,500 for the cost of services provided by AES is appropriate in this case as shown on Attachment A. Atmos agrees to engage Mr. Patrick Baryenbruch to review the costs and market availability of AES' services based on 2004 information. Mr. Baryenbruch's study will be filed with the Staff and Consumer Counsel approximately mid-year 2005. Staff and Consumer Counsel reserve all rights to challenge the results of the Baryenbruch study and to submit other evidence regarding the issues addressed therein but such challenges shall not affect retroactively the rates determined in this proceeding.

7. The Stipulating Participants agree to a modification of the Staff customer growth rate adjustment as shown on the revenue requirement calculation on Attachment A.

8. The stipulating Parties agree that the 30 year rolling average heating degree days are appropriate for use in both the Weather Normalization Adjustment ("WNA") discussed below and the weather adjustment used to determine revenue requirement. Utilizing the 30 year rolling average heating degree days will produce an additional annual revenue requirement in the amount of $143,005, as shown on Attachment A.

9. The Company agrees to refund the five-month overcollection of Gas Technology Institute funding through the Purchased Gas Adjustment ("PGA") mechanism.

10. The Company agrees to continue use of the Average Life Group methodology for purposes of accruing depreciation expense, and the date of the implementation of revised

depreciation rates resulting from the depreciation study provided with the Company's rate application shall be October 1, 2003, the date of the study.

11. The Company agrees to implement the use of direct charges or allocations whenever practical.

12. This Stipulation shall result in an annual revenue requirement of $371,735 as shown on Attachment A, which revises Staff witness Taylor's Statement V.

13. The Stipulating Participants agree that the Company shall file tariffs prepared in conformance with this Stipulation with the Commission for its review and approval.

14. The Stipulating Participants agree that the Company has a legitimate right to require all owners or bona fide lessees of a residence to make application for service and be jointly responsible for making timely payments. The tariff provision to implement this process is shown on Attachment B to this Stipulation.

15. The Company agrees to withdraw its proposed door tag fee of $15. The Stipulating Participants agree that the Company shall implement an account activation charge of $40 for both new service and for the reconnection of an existing customer whose service has been disconnected for nonpayment of a bill. Furthermore, this $40 account activation charge shall apply to those customers that require a reconnection where the service has been previously disconnected at the customer's request. The Stipulating Participants agree that the Company shall implement a "soft close" procedure as set forth in tariff language attached to this Stipulation as Attachment C and that gas will remain on at a premise for 45 days or until 50 Ccf of gas consumption, which ever occurs first. The Company will submit revised "soft close" operating and maintenance procedures to the Division of Utility and Railroad Safety. The Stipulating Participants agree that the Company shall implement a meter-read only turn-on charge of $20.

The Stipulating Participants agree that no change is required in the existing returned check charge of $20.

16. The Company agrees to withdraw its request to recover certain newly instituted federal, state and local taxes (including franchise fees) as a line item on a customer's bill.

17. The Stipulating Participants agree that the Company may recover third party vendor fees from those customers electing that particular payment option. In addition, the Stipulating Participants agree that the Company may implement the following four changes to the Company's PGA Rider:

A. the Company may include interest on the Actual Gas Cost ("ACA") balances;

B. the Company may include within the ACA the gas cost portion of uncollectible accounts that are written-off;

C. the Company will have the option to project billing determinants, sales volumes and supplier rates in its PGA calculations; and

D. the Company may remove the credit for Company use from the ACA.

18. The Stipulating Participants agree that the Company may implement a practice of bi-monthly meter reading during the months of May through October, but no customer may receive two estimated bills in succession. In addition, monthly meter reading will be required during the months of November through April. Actual meter reads will be performed to initiate new customers and to close out accounts.

19. The Stipulating Participants agree that the Company shall change the eligibility of Rate Schedule 630 and Rate Schedule 640, applicable to transportation service, to allow customers whose daily usage would not qualify for this service under the current minimum of 1,000 Ccf per day to qualify as long as their annual usage exceeds 100,000 Ccf. In addition, the

Stipulating Participants agree that the Company shall amend Rate Schedule 640, applicable to Industrial and Optional Gas Service, to address "capacity release" of the Company's contracted-for upstream pipeline capacity.

20. The Company agrees to adopt a WNA method similar to that adopted by the Commission for Roanoke Gas Company in Case No. PUE-2002-00373. The WNA will consist of two calculations divided into an eastern portion of the service territory (Blacksburg, Christiansburg, Dublin, Pulaski and Radford) and western portion of the service territory (Abingdon, Chilhowie, Marion and Meadowview). The agreed upon tariff language is attached to this Stipulation as Attachment D. The agreed upon WNA includes the following features:

A. Atmos will use the same weather stations as it uses for weather revenue normalization;

B. WNA customer billing credits or charges shall be over a 12-month period with a true-up provision; and

C. A band for customer billing credits or charges expected to be triggered approximately 50% of the years.

21. The Stipulating Participants agree to a rate design as shown on Attachment E to collect the increased revenue requirement. The annual revenue increase from the stipulated rate design is shown on Attachment F, which includes Company witness Petersen's revised Schedule 21, Workpaper 32-1 and Schedule 32.

22. The Stipulating Participants agree that the Company shall refund the difference between the rates that went into effect on July 27, 2004, and those set forth in this Stipulation. These refunds, along with interest at the Commission-determined rate, will be initiated as credits to customers' bills commencing within 90 days of the Commission's Final Order in this case.

23. In consideration for the compromises set forth in this Stipulation, the Company agrees not to file an application for an increase in rates by which rates would become effective prior to July 1, 2006 ("filing moratorium"), except under the conditions set forth in Va. Code § 56-245.

24. The Stipulating Participants agree that this Stipulation represents a compromise for the purposes of settlement in this case only and shall not be regarded as a precedent with respect to any ratemaking or any other principle in any future case. None of the Participants to this Stipulation necessarily agree or disagree with the treatment of any particular item, any procedure followed, or the resolution of any particular issue in agreeing to this Stipulation other than as specified herein, except that the Participants agree that the resolution of the issues herein, taken as a whole, and the disposition of all other matters set forth in the Stipulation are in the public interest. This Stipulation is conditioned on and subject to acceptance by the Commission and is non-severable and of no force or effect and may not be used for any other purpose unless accepted in its entirety by the Commission, except that this paragraph shall remain in effect in any event.

In the event the Hearing Examiner does not recommend acceptance of the Stipulation by the Commission or the Commission does not accept the terms of the Stipulation in its entirety, then each of the signatories to the Stipulation retains the right to terminate the Stipulation. In the event of an action by the Hearing Examiner or Commission to modify the terms of the Stipulation, the signatories to the Stipulation may by unanimous consent elect to modify the Stipulation to address the issues raised by the Commission or Hearing Examiner. Should the Stipulation terminate, it shall be considered void, and the signatories to the Stipulation reserve their rights to participate fully in all relevant proceedings in the captioned case notwithstanding their agreement on the terms of the Stipulation.

Respectfully submitted this 4th day of November 2004.

ATMOS ENERGY CORPORATION

By______________________
Counsel

STAFF OF THE STATE CORPORATION COMMISSION

By Robert M. Gillespie
Counsel

ATTORNEY GENERAL, DIVISION OF CONSUMER COUNSEL

By______________________
Counsel

Richard D. Gary
D. Zachary Grabill
Hunton & Williams LLP
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219-4074
Counsel for Atmos Energy Corporation

Robert M. Gillespie
Sherry H. Bridewell
State Corporation Commission
Tyler Building, 10th Floor
1300 East Main Street
Richmond, VA 23219
Counsel for the Staff of the
State Corporation Commission

C. Meade Browder
D. Mathias Roussy, Jr.
Insurance and Utilities Regulatory Section
Office of the Attorney General
900 East Main Street
Richmond, VA 23219

ATTACHMENT A

Attachment A

EXHIBIT NO.____
WITNESS: TAYLOR
STATEMENT V
REVISED

ATMOS ENERGY CORPORATION
RECONCILIATION OF COMPANY AND STAFF
REVENUE REQUIREMENTS
CASE NO. PUE-2003-00507

Description	Change In Revenue Requirement	Total Revenue Requirement
Revenue Requirement Per Company Schedule 15		949,111
Per Book Differences	(85,158)	863,953
Previously Approved Adjustments		
Revenue Annualization and Weather Normalization	41,378	905,331
Customer Growth, Migration, Pulled Meters	(100,252)	805,079
Uncollectible Expense	22,537	827,616
Payroll and Benefits	(18,936)	808,680
Overallocated Expenses	(277,906)	530,774
AES Fees	(127,546)	403,228
Advertising and Jobbing and Service	4,484	407,712
Depreciation	(149,476)	258,236
Capitalized Overhead	(41,507)	216,729
Income Taxes	85,513	302,242
Taxes Other Than Income Taxes	63,592	365,834
Other Deductions	(16,958)	348,876
Updated Rate Base	131,132	480,008
Changes in Capital Structure and Cost Rates	10,771	490,779
Change in Return On Equity From 12.00% to 9.80%	(416,445)	74,334
Staff Revenue Requirement as Filed		74,334
Revisions Per Stipulation		
Weather Normalization	143,005	217,339
Customer Growth	15,396	232,735
AES Fees	53,500	286,235
Capital Structure	37,856	324,091
ROE	47,644	371,735
Revenue Requirement Per Stipulation		371,735

Exhibit No. ____
Witness: Ballsrud
Schedule 3
Per Stipulation

Atmos Energy Corporation
Consolidated Capital Structure
Updated per Stipulation
As of September 30, 2003

Component	Net Amount Outstanding	Weight (%)		Cost Rate (%)		Weighted Cost (%)		
Short-term Debt (1)	$ 73,609	4.115%		1.537%	(3)		0.063%	
Long-Term Debt (2)	854,245	47.758%		7.412%	(4)		3.540%	
Common Equity	857,517	47.941%	9.500%	10.000%	10.500%	4.554%	4.794%	5.034%
Inv. Tax Credits	3,322	0.186%	8.458%	8.709%	8.959%	0.016%	0.016%	0.017%
Total Capitalization	$ 1,788,693	100.000%				8.173%	8.413%	8.654%

Component	Net Amount Outstanding	Weight (%)		Cost Rate (%)		Weighted Cost (%)		
Long-Term Debt	$ 854,245	49.904%		7.412%			3.699%	
Page 2 of 2								
Common Equity	857,517	50.096%	9.500%	10.000%	10.500%	4.759%	5.010%	5.260%
	$ 1,711,762	100.000%				8.458%	8.709%	8.959%

Notes:

1. 12-month daily average balance outstanding, adjusted to remove MVG credit facility.
2. net amount outstanding, end of test period.
3. proxy rate of interest on 30 day commercial paper for the most recent three months (July, August & September).
4. cost of long-term debt reflects the inclusion of line of credit fees totaling $2,692,966.

ATTACHMENT B

Attachment B

GENERAL RULES AND REGULATIONS

1. Definitions

Except where the context indicates a different meaning or intent, the following terms, when used herein or in the Company's rate schedules incorporating these General Rules and Regulations, shall have the meanings defined below:

1.1 "Company"

Atmos Energy Corporation.

1.2 "Customer"

Any individual, partnership, firm, organization, or governmental agency receiving service at one location though one or more active meters are billed under one rate classification, contract or rate structure.

<u>The Company may, prior to initiating service and at other reasonable times, require Customer to establish that Customer is the owner or bona fide lessee of the premises and to require all owners and bona fide lessees to have the service in their names. All such persons shall be deemed Customers under this section.</u>

ATTACHMENT C

GENERAL RULES AND REGULATIONS (Continued)

When a customer requests termination of gas service, this option is presented. Upon choosing this option, the customer is given a list of safety steps they are requested to follow to reduce the possibility of danger and to minimize the gas used. These steps are:

(a) Lower all thermostats.

(b) Check operating status of appliances and ensure all settings are in the off position.

(c) All gas lines must be properly capped and plugged if appliances are removed from the structure.

A final meter read is performed and a final bill issued. A door tag is left notifying anyone approaching that gas service is "ON". The gas service will remain on until either 45 days or 50 Ccf of consumption occurs, whichever comes first. If the technician discovers that a tenant has moved into the location without notifying the Company, field personnel will leave a door tag with a 48-hour notice for the new tenant to contact the Company to transfer service into their name. If no contact is made within the 48-hour period, a disconnect order is issued. A read charge of $20.00 will be assessed where gas service has remained on in accordance with 5.3 and only a meter read is required.

5.4 Restoration of Service; Reconnection Charge; Returned Check Charge

Service which is discontinued by the Company for Customer's nonpayment of bills, failure to comply with applicable service regulations, or at Customer's request including turn on from a seasonal off, may be restored upon payment by Customer of all indebtedness for gas service and a charge of $40.00 for reconnection during regular office hours.

When the Customer pays by check which is returned to the Company marked NSF (Not Sufficient Funds) the Customer will be assessed a charge of $20.00 additional cost.

The Company may require that service be on a cash payment basis if more than one of such Customer's checks is returned marked NSF in a twelve month period. Cash will be deemed to be U.S. currency, U.S. postal money order, or certified check.

6. Extension and Installation of Company Facilities

The Company will, upon written application, extend its gas mains to serve bona fide applicants of a permanent and established character in accordance with the provisions of this Service Regulation. Gas main extensions shall be made only along public streets, roads and highways and upon private property across which satisfactory rights of way or easements have been provided without cost to the Company. All gas mains constructed pursuant to this service regulation shall be owned, operated and maintained by the Company.

6.1 Free Extension Allowance

Gas mains will be extended by the Company to supply new Customers, without additional charge for any extension, provided the length of such extension meets the requirements stated below:

(a) Residential Customers

(1) In determining the free length allowance for a new customer, the free length allowance, if any, will be determined on an individual feasibility basis considering the required investment, character and economic life of the load, and other appropriate information.

ATTACHMENT D

Attachment D

WEATHER NORMALIZATION ADJUSTMENT

APPLICABILITY

The Weather Normalization Adjustment will become effective on July 1, 2005 for the eight month period of August 1, 2004 through March 31, 2005 and will be applicable for each twelve month period, thereafter. The Weather Normalization Adjustment is applicable to service delivered under the terms of rate schedules 610 and 620 throughout the entire service area of the Company when the annual heating degree days from April to March in a given period are outside the upper or lower band of heating degree days based on the most recent 30-year average of heating degree days. A separate Weather Normalization Adjustment will be calculated for customers in each rate schedule in each weather zone. The East weather zone shall include all customers in and adjacent to Blacksburg, Radford, Pulaski and Wytheville. The West weather zone shall include all customers in and adjacent to Bristol, Marion and Abingdon. For the East weather zone, the upper and lower band is defined as 4.36% above and/or below the most recent 30-year average. For the West zone, the upper and lower band is defined as 5.63% above and/or below the most recent 30-year average.

2. CALCULATION OF ADJUSTMENT

The Weather Normalization Adjustment Factor will be calculated for each customer class and weather zone as follows:

(1) Ccf Volume Adj. = (HDD Normal – HDD Actual) * M * (Annual no. of bills /12)

(2) Total Revenue Adjustment = Volume Adj. * Non-Gas Commodity Margin

(3) Adjustment Factor Per Ccf = Total Rev Adj. / Most Recent 12 Months Actual Ccf

(4) Any residual balance (positive or negative) as a result of actual Weather Normalization Adjustment revenue collected compared to the total revenue adjustment set forth in (2) above shall be added to the following year's revenue adjustment amount.

Note: M will be the slope of the regression equation for the adjustment period for each rate schedule and weather zone.

Note: HDD Normal is defined as the HDD value corresponding to the top or bottom of the appropriate band, whichever is applicable.

3. BILLING

All adjustments, if applicable, will be included as an adjustment factor per Ccf as set forth in (3) above and will be effective for the 12 month period of August through July for the preceding Weather Normalization Adjustment period.

4. LATE PAYMENT CHARGE

Any late payment penalties applicable to a customer's bill will also apply to Weather

Normalization Adjustment amounts.

5. TAXES

Weather Normalization Adjustments will be subject to any effective tax based upon revenue receipts levied by governing bodies.

ATTACHMENT E

Attachment E

	PRESENT	STIPULATED RATE		
CLASS	RATE	RATE	CHANGE	PERCENT
Residential (610)				
Customer Charge	$6.00	$6.60	$0.60	10.00%
Commodity Charge	0.1494	0.1494	0	0.00%
Small Commercial (620)				
Customer Charge	$12.50	$14.50	$2.00	16.00%
Commodity Charge	0.1121	0.1121	0	0.00%
Large Commercial (630)				
Customer Charge	$165.00	$167.00	$2.00	1.21%
Commodity Charge	0.0768	0.0768	0	0.00%
Industrial and Optional (640)				
Customer Charge	$350.00	$435.00	$85.00	24.29%
Demand Charge	0.0103	0.0103	0	0.00%
Commodity Charge	0.0354	0.0356	0.0002	0.56%
Optional and Transport (650)				
Customer Charge	$283.00	$325.00	$42.00	14.84%
Commodity Charge	0.0354	0.0356	0.0002	0.56%

ATTACHMENT F

Exhibit No. ___
Witness: THP
Schedule 21
WORKPAPER 32-1

ATMOS ENERGY CORPORATION-VIRGINIA
PROPOSED JURISDICTIONAL OTHER REVENUES
FOR TEST YEAR ENDED September 30, 2003
CASE NUMBER PUE-2003-00507

Line No.	Rate Code	Description	2003 Amount	AS SETTLED New Charges or Increase in Current Charge	SETTLED Additional Annual Revenue
	(a)	(b)	(c)	(f)	(g)
1		Door Tags	4,101	$ -	-
2		New Customer	426	$ 40.00	17,040
3		Reconnect Delinquencies (1)	1,215	$ 10.00	12,150
4		Read and Run	2,589	$ 20.00	51,780
5		Meter Activiation	740	$ 40.00	29,600
6		Turn On-Expect to be read & run	1,110	$ 20.00	22,200
7		Estimated NSF Checks	1,200	$ -	-
8					
9					132,770
10					
11		Current Revenue			
12					
13		TOTAL JURISDICTIONAL OTHER REVENUES			

ATMOS ENERGY CORPORATION-VIRGINIA
PRESENT AND PROPOSED REVENUES
FOR TEST YEAR ENDED September 30, 2003
CASE NUMBER PUE-2003-00507

Line No.	Rate Code	Description	ADJUSTED Number of Bills/ Ccf	CURRENT Customer/ Commodity Charge	Customer Revenues	SETTLED Customer/ Commodity Charge	PER STIPULATION SETTLED Customer Revenues	SETTLED INCR IN Revenues
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
1	610	Residential	206,841	$6.00	1,241,046	$6.60	1,365,151	124,105
2	620	Small Commercial and Industrial	43,431	$12.50	542,888	$14.50	629,750	86,862
3	630	Large Commercial and Industrial	728	$165.00	120,120	$167.00	121,576	1,456
4	640	Industrial Firm & Interruptible	95	$350.00	33,250	$435.00	41,325	8,075
5	650	Optional Gas Service	212	$283.00	59,996	$325.00	68,900	8,904
6	665	Transportation	79	$283.00	22,357	$325.00	25,675	3,318
7	692.3	Cogeneration and Gas A/C	29	$12.50	363	$14.50	421	58
8		Total Customer Charges	251,415		$ 2,020,019		$ 2,252,797	232,778
9								
10	640	Industrial Firm & Interruptible - commodity	12,004,890	$0.0354	424,973	$0.0356	427,374	2,401
11	650	Optional Gas Service	10,575,997	$0.0354	374,390	$0.0356	376,505	2,115
12	665	Transportation	9,003,600	$0.0354	318,727	$0.0356	320,528	1,801
13	692.3	Cogeneration and Gas A/C	69,785	$0.0354	2,470	$0.0356	2,484	14
14		Total Commodity Charges	31,654,272		$ 1,120,561		$ 1,126,892	6,331
15								
16		*Juris. Other Revenues Increase*						$132,770
17								
18		SETTLEMENT RATE DESIGN						$371,878
19								
20		SETTLEMENT REVENUE REQUIREMENT						$371,735
21								
22		DIFFERENCE						$143