BEFORE THE TENNESSEE PUBLIC SERVICE COMMISSION
NASHVILLE, TENNESSEE

January 23, 1996

IN RE: APPLICATION OF BELLSOUTH TELECOMMUNICATIONS, INC., d/b/a/ SOUTH CENTRAL BELL TELEPHONE COMPANY FOR A PRICE REGULATION PLAN

DOCKET NO. 95-02614

ORDER

This matter is before the Commission on the application of BellSouth Telecommunications, Inc. d/b/a South Central Bell Telephone Company (hereafter "Bell") for price regulation pursuant to T.C.A. 65-5-209. On September 20, 1995, this Commission entered an Order adopting the Staff audit of Bell's TPSC 3.01 Report for the twelve months ended March 31, 1995. The audit, conducted in accordance with T.C.A. 65-5-209(c) and (j), revealed Bell's rate of return to be 12.74%, well above the Authorized Rate of Return, set at 10.65-11.85%

Because Bell's earned rate of return exceeded the Authorized Rate of Return, the Commission initiated a contested, evidentiary proceeding to set initial rates. The Commission directed that the proceeding be conducted in two parts. In the first session, on November 1, testimony was admitted to determine a fair rate of return on Bell's rate base. This decision was deliberated and announced at the November 7 Commission Conference. In the second session, on November 20, the Commission heard rate-design proposals for the purpose of setting initial rates. On November 30, the Commission convened to deliberate and decide what initial rates were just, reasonable, and therefore, affordable.

The Commission previously adopted the Staff's audit in its Order of September 20, 1995. The Commission has further determined that the type of adjustments made by Commission Staff in conducting the audit are permitted by law. See Commission Order of November 9, 1995. The Commission takes notice of its prior Orders of September 20, 1995 and of November 9, 1995. Also, the Commission had before it the Audit Findings derived from the Staff's Audit of the 1995 TPSC 3.01 Report. See Exhibit 7.

Based on the record before the Commission, we make the following findings:

FINDINGS OF FACT

1. Bell's case consisted of testimony, which went to support what Bell's Rate of Return would have been but for the adjustments made in the Audit. Mr. Guy Cochran, Assistant Chief Accountant for Bell, urged the Commission to find that Bell's actual results were 10.20% for the twelve (12) months ended March 31, 1995. In rebuttal, the Consumer Advocate Division (hereafter CA) put on Mr. Archie Hickerson, Division Director, who disagreed with Mr. Cochran and opined that the Staff adjustments were properly made. He went further, however, to

propose that several adjustments, in addition to ones made by the staff, should be made to accurately reflect the company's earnings through March 1995 TPSC 3.01. Mr. Hickerson testified that an updated audit report would reveal that Bell's actual rate of return would be 14.50%. The Commission did not find that any party provided support in law to justify reconsideration of their adoption of the Staff Audit return of 12.74%.

Having found Bell to be earning above the range, the next step required by the statute is that the Commission make a finding of a fair rate of return. To do this, the Commission must determine an appropriate return to the common equity holder, which when incorporated into the appropriate capital structure of debt and equity, ultimately yields a fair rate of return. Bell put on their expert witness, Dr. James VanderWelde, Research Professor of Finance at Duke University. The CA put on their expert witness, Dr. Stephen Brown, Economist, Consumer Advocate Division.

2. Bell's witness, Dr. VanderWelde, testified that, using a discounted cash flow model and a risk premium model to estimate a fair rate of return, Bell should be permitted to earn in the range of 12.8-14% on equity. Dr. Brown, on behalf of the CA, using a discounted cash flow (DCF) model and a risk premium model, proposed a rate of return on common equity in the range of 9.74-11.01%. The distinction between the two lay in Dr. Vanderwelde's use of a quarterly DCF applied to comparable non-telecommunications firms while Dr. Brown used a continuous DCF applied to Bell and the Regional Bell Holding Companies(RBHC). The Commission has concerns about both methodologies based on their failure to adequately account for both the timing effect of quarterly dividend payments and a company's ability to continuously earn profits; and second, the testimony of the two experts regarding comparison of comparable firms, i.e. relative rates of return. Dr. Brown reviewed each company presented by Dr. VanderWelde. In doing so, he illustrated that there was no basis for comparison between Bell and the dissimilar companies. If there is no basis for comparison, Dr. VanderWelde's conclusions may have minimal relevance to a "fair rate of return on equity." As to Dr. Brown's own comparisons, he candidly admitted that, though his DCF analysis was correct, it might be given less weight because of the disparity in earnings and dividend growth rates for the RBHC's.

Each expert criticized the risk premium method proposed by the other. However, the Commission finds that both methods have merit. The risk premium method proposed by Dr. Brown indicated a fair return to equity of 11.01% while Dr. VanderWelde's method indicated 13.2%.

After considering the testimony of witnesses and the entire record in this portion of the price regulation proceeding, the Commission determined the fair return on equity to be 12.5%. By applying this equity return and the actual debt cost to the actual capital structure, taken from Bell's March 1995 TPSC 3.01 Report, the Commission finds that a cost of capital/fair rate of return of 10.35% is reasonable and is adopted.

3. The fair return on rate base of 10.35% applied to the rate base adopted in the Staff Audit results in an excess revenue requirement of $56.285 million. It was the decision of the Commission that the next portion of the proceeding would consider argument from the parties regarding how to design the Bell rates or, specifically, how to allocate the $56.285 million to reduce rates.

4. On November 20, the Commission convened to hear rate design proposals to reduce rates by $56.285 million from these parties: AT&T Communications of the South Central States (hereafter AT&T), Bell, and the CA.

AT&T proposed a reduction of switched access charges to cost: a proposal which AT&T admitted would cost $77 million, or more than $20 million over the actual reduction which was adopted.

Bell proposed four changes: 1) to make-up a $7.7 million deficit in the deferred revenue account to pay for rate reductions ordered in 1993; 2) to reduce the local switching component of intrastate switched access by $12.9 million; 3) to reduce IntraLATA toll rates by $20.2 million; and 4) to utilize $15.5 million toward additional depreciation expense as part of the depreciation rate represcription process.

CA proposed four changes: 1) to reduce rates by $27.4 million by eliminating the Touchtone charge for residential customers; 2) to reduce rates by $21.1 million reflecting expansion of the local calling areas for Metro Area Calling; 3) to reduce rates by $7.4 million reflecting the elimination of zone charges; and 4) to pay a maximum of $0.4 million for a competitive impact study to be submitted to the Legislature as part of the two-year evaluation of local competition required by the Telecommunications Reform Act of 1995.

5. The Commission agreed that, as a matter of policy, the most appropriate rate design should benefit the greatest number of consumers and ratepayers in all counties served by Bell across the state.

Accordingly, the Commission adopts the following rate design:

a. The IntraLATA long distance message toll rates (MTS) shall be reduced by $21.5 million. The reduction shall be applied to:
   (1) provide free interLATA countywide calling;
   (2) reduce all MTS rate band per minute rates above $0.19 to $0.19;
   (3) provide subminute MTS pricing: and
   (4) use any remainder to further reduce MTS rates.

b. The $1.50 residential Touchtone charge shall be eliminated, a calculated reduction of rates by $27.4 million.
c. The $1.00 zone charge shall be eliminated, a calculated reduction of rates by $7.4 million.
d. Service connection charges for computer lines at schools and libraries shall be waived.
e. Bell should give customers "who have expressed a need to be included in Metro Area Calling" a flat-rate option in lieu of measured long-distance rates.

6. In order to enable Bell to apply part of the $21.5 million to provide free interLATA countywide calling as designated in subsection 5(a)(1), Bell must secure a waiver from the United States District Court for the District of Columbia in U.S. v. Western Electric Co., Inc. and AT&T. That waiver, when granted, shall modify the District Court's Order by permitting Bell to provide local exchange service across LATA boundaries solely for the purpose of providing countywide local telephone calling service.

7. AT&T put on witnesses whose testimony included statements reiterating their request that each rate Bell seeks to impose should be reviewed prior to the implementation of price regulation. In the United Telephone-Southeast, Inc. Price Regulation Order of October 13, 1995, the Commission denied AT&T's Motion to convene a hearing in order to construe certain provisions of Title 65, as amended by Chapter 408 of the Public Acts of 1995 and by Chapter 305 of the Public Acts of 1995. We did so based on the absence of authority, under the law, for the Commission, to make any further finding with regard to rates except as we set out in the provisions of the United Order. No testimony by these witnesses provides support for any basis to find differently here.

CONCLUSIONS OF LAW

Since the enactment of the Telecommunications Reform Act in June 1995, the Commission is guided by the provisions of T.C.A. 65-5-209 in establishing "just and reasonable rates" for an incumbent Local Exchange Telephone Company (LEC). This law sets out that...

> Rates for telecommunications services are just and reasonable when they are determined to be affordable as set forth in this Section. Using the procedures established in this section, the Commission shall ensure that rates for all Basic Local Exchange Telephone Services and Non-Basic Services are affordable on the effective date of price regulation for each incumbent LEC. T.C.A.65-5-209 (a).

Prior to the enactment of this law in June 1995, the Legislature had delegated to the Commission the power to fix rates that are "just and reasonable." T.C.A. 65-5-201 The Legislature has now determined that, for purposes of a price regulation plan, rates are just and reasonable when they are "affordable." T.C.A. 65-5-209(a)

The Commission is authorized to find these rates "affordable" by observing the entirety of T.C.A. 65-5-209. In the case of an incumbent whose rate of return, as determined from an audit of its most recent TPSC 3.01, was greater than its Authorized Rate of Return, the Commission was under a mandate to initiate a contested, evidentiary hearing to establish initial rates. The proceeding is to be conducted in accordance with the Uniform Administrative Procedures Act. T.C.A. 4-5-101 et. seq.

Determination of a fair rate of return is an issue separate and apart from setting the rates. For that reason, the Commission bifurcated the proceeding and first set a hearing to determine a fair rate of return. Evidence was submitted as to cost, capital investment, relative rates of return and other factors. It is well established that the Commission is required to consider rate base, revenues, and expenses of the utility and a fair rate of return based on long-term debt, common equity and other underlying considerations when setting rates. CF Industries v. TPSC, 599 SW2d 536 (Tenn 1980).

Rate design, on the other hand, has been largely a decision left to the specialized knowledge and technical expertise of the Commission. The Commission may...

> consider all relevant circumstances shown by the record, all recognized technical and scientific facts pertinent to the issue under consideration and may superimpose upon the entire transaction its own expertise, technical competence and specialized knowledge. Thus, focusing upon the issues, the Commission decides that which is just and reasonable. This is the litmus test–nothing more, nothing less. Id. at 543.

Having considered the testimony of witnesses and the entire record compiled in the rate making and rate design proceedings,

IT IS THEREFORE ORDERED

1. that, in order that their rates be "affordable", Bell shall reduce rates by $56.285 million by the specifically designed distribution set forth in Section 5;

2. that, in order that their rates be "affordable", Bell shall file tariffs to accomplish the rate design set out in Section 5(a) through (d) within twenty (20) days from the entry of this order;

3. that Bell shall proceed within ten (10) days of entry of this order to properly petition the United States District Court for the District of Columbia in U.S. v. Western Electric Co., Inc. and AT&T to modify the Court's Final Judgment so that Bell is permitted to provide local exchange service across LATA boundaries for the purpose of providing countywide local telephone calling service and shall provide to this Commission a copy of this petition verifying same;

4. that the effective date of the tariffs set forth above and the effective date of price regulation for Bell occur on the same day but in no circumstance is the effective date of price regulation to occur until and unless Bell properly petitions the U.S. District Court for the waiver as set forth above;

5. that the allocation of the $56.285 million shall not be applied to administrative costs or legal fees associated with the implementation of the rate reduction outlined in this order;

6. that Bell shall charge and collect for Basic and Non-Basic Services only such rates less than or equal to the maximum permitted by T.C.A., Title 65, Chapter 5 (the Act);

7. that Bell shall adhere to a price floor for its competitive services subject to such determination as the Commission shall make pursuant to T.C.A. 65-5-207;

8. that Bell shall adhere to the safeguards set forth in T.C.A. 65-5-208(c) and (d) and all non-discrimination provisions of Title 65;

9. that Bell shall comply with all Competitive and Administrative Rules and such Orders as are issued by the Commission regarding support of universal service and such additional rules issued by the Commission under Title 65, Chapter 5, including interconnection, resale, intraLATA equal access, unbundling, number portability and packaging of Basic Services;

10. that, notwithstanding the annual adjustments permitted in T.C.A. 65-5-209(e), the initial Basic Service rates for Bell shall not increase for a period of four years from the date of entry of this Order. At the end of this four-year period, Bell shall only be permitted to adjust annually its rates for Basic Services in accordance with the method set forth in T.C.A. 65-5-209(e) provided that the limitations and safeguards set forth in the Act are followed with regard to any increase in rates;

11. that Bell's rates for Non-Basic Services shall be set as the company deems appropriate, subject to the limitations set forth in T.C.A. 65-5-209(e) and (g), the non-discrimination provisions of this Title, any rules or orders issued by the Commission pursuant to Section 65-5-208(c) and upon requisite prior notice to all affected customers;

12. that Bell shall maintain its commitment to the FYI Tennessee Master Plan to the completion of the funded requirements and any adjustments to the plan are to be approved by the Commission; and

13. that Bell shall comply with their business participation plan, filed with the Commission pursuant to Section 16, Chapter 408, Public Acts of 1995.

IT IS FURTHER ORDERED THAT

1. the request of AT&T that we review each rate prior to price regulation is hereby denied as being in excess of the authority with which we have been empowered;

2. all other motions filed or pending as of the date of this Order and not specifically ruled upon are hereby denied.

3. Any party aggrieved with the Commission's decisions of this matter may file a Petition for Reconsideration within ten (10) days from entry of this Order.

4. Any person aggrieved with the Commission's decisions of this matter has the right to judicial review by filing a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty (60) days from entry of this Order.

CHAIRMAN

COMMISSIONER

COMMISSIONER

ATTEST:

EXECUTIVE DIRECTOR