DT 01-149

UNION TELEPHONE COMPANY

Investigation Into Overearnings

Order Approving Comprehensive Settlement

O R D E R N O. 23,791

October 1, 2001

APPEARANCES: Joseph G. Donahue, Esq., of Preti, Flaherty, Beliveau, Pachios & Haley for Union Telephone Company; Anne Ross, Esq. and Kenneth Traum, of the Office of Consumer Advocate on behalf of Residential Ratepayers; and Lynmarie Cusack, Esq., for the Staff of the New Hampshire Public Utilities Commission.

I. BACKGROUND AND PROCEDURAL HISTORY

On July 26, 2001, the New Hampshire Public Utilities Commission (Commission) issued an Order of Notice opening an inquiry to examine the current earnings of Union Telephone Company (Union or Company) and to determine whether rates being charged by the Company are just and reasonable. The facts which influenced the opening of the investigation show that in August 2000, Commission Finance Staff completed a desk audit of Union Telephone Company's 1999 Annual Report that concluded that Union was earning in excess of its authorized rate of return.

The Order of Notice also scheduled a prehearing conference, held on August 13, 2001, over which a Hearings Examiner presided. After the prehearing conference, on August 17,

2001, Staff, the Company and the Office of Consumer Advocate (OCA) (together the Parties) submitted a Stipulation agreeing: that temporary rates would be established at current permanent rate levels as of July 26, 2001; that the administration of any refund or recoupment should be addressed in any final settlement, or by the Commission following a hearing if no settlement were reached; and that calendar year 1999 (with adjustments for known and measurable year 2000 changes) would be used as the test year for this earnings investigation.

On September 7, 2001, the Commission issued Order No. 23,771, relating to the prehearing conference. The Order addressed the procedural schedule for the case but also indicated that the schedule was superceded by Staff's August 30, 2001, representation that the Parties had come to a final resolution on the issues presented in the docket without the need for protracted litigation. On September 21, 2001, Staff and the Parties submitted the Comprehensive Settlement Agreement, which summarized a recommended negotiated resolution to the docket.

A hearing on the Comprehensive Settlement Agreement was held on September 21, 2001. The Staff presented Ms. Mary Hart, Utility Analyst III, of the Commission's Finance Department, as a witness to expound upon the negotiated agreement. The Commission queried Ms. Hart on various aspects of

the Comprehensive Agreement. As a result of the inquiries a number of late filed exhibits were presented to the Commission on September 26, 2001.

II. TERMS OF THE COMPREHENSIVE SETTLEMENT

The Staff and the Parties agreed that the Company shall file and implement tariffs effective October 1, 2001, which are designed to produce a total reduction in the Company's annual revenues of $440,000. The revenue reductions are to be achieved through decreases in intrastate access rates and intrastate toll rates. The access rate reduction is designed to reduce annual intrastate access revenues by $375,000, by reducing all intrastate access rates to the current National Exchange Carriers Association (NECA) Tariff No. 5, with the exception of the Carrier Common Line – Terminating charge, which would be reduced only to a level needed to reduce revenues to the agreed-upon overall access reduction.

The toll rate reduction is designed to result in a reduction in annual revenues of $65,000. It is estimated that a new optional toll plan that provides for intrastate toll calling at $0.10 per minute with no monthly fee will form the basis of the reduction. To insure the plan is widely disseminated the Company is required to provide notice to its customers of the new optional toll plan in its October billing.

The Staff and Parties also agreed that the Company would not seek to recover any rate case expenses associated with this proceeding in any future rate proceeding. Along that line, the Parties and Staff agreed that neither the Company nor the Staff would initiate a rate proceeding before December 31, 2002.

Additionally, the Staff and Parties agreed that this Comprehensive Agreement supercedes the August 17, 2001 Agreement regarding temporary rates. The Parties and Staff therefore ask that the August 17, 2001 Agreement be withdrawn. The Comprehensive Settlement also provides that there would be no true-ups concerning the temporary rates that have been effect in the proceeding since July 26, 2001.

III. COMMISSION ANALYSIS

The Commission has general authority under RSA 541-A: 31,V (a) to resolve contested matters through consideration of settlement agreements. In *Appeal of Richards*, 134 NH 148 (1991), the New Hampshire Supreme Court upheld the Commission's authority to resolve rate issues through the consideration of settlements. The Court reiterated that the Commission was not required to use any particular rate-making formula to set rates. The end-inquiry is whether the rates established are just and reasonable. *See Appeal of Richards*, 134 NH at 164, citing *Federal Power Commission v. Hope Natural Gas Co.*, 320 US 592, 620 (1944).

We, therefore, will analyze this Settlement Agreement based on our traditional standard of whether the Agreement will result in rates that are just and reasonable and in the public good. This essentially requires us to strike a balance between the interest of the Company and the interests of New Hampshire and its ratepayers.

In general, the Commission regards stipulations, settlements, and negotiated compromises as desirable and as reasonable options to be considered in the regulatory process. *Re Generic Investigation Into IntraLATA Toll Competition*, 78 NH PUC 283, 284(1991). We have also said in encouraging "the consideration of settlements, we accord significant deference to stipulations in our public interest analysis." *Id.* In fact, "[r]ather than insisting that any stipulation match the relief that the Commission would have ordered had the matter proceeded to final decision, we will approve stipulated settlements so long as we are satisfied on balance that the settlement promotes the public interest." *Id.*

Turning to the particular matter before us, we note that this earnings investigation presents a number of important issues. Of prime importance is the question whether and to what extent the Company's rates, on average, produce excessive returns to the Company, and are therefore unjust and unreasonable. In

addition, the Commission must consider the proper allocation of any revenue reduction to the various classes of customers who take service from the Company. In turn, this review involves a consideration of how to determine the cost basis for any given service, or the associated revenue requirement for any given class of customers, including the Company's wholesale customers who buy access in order to offer interexchange service.

The Settlement Agreement rate reductions are forecast to reduce revenues by about 14 percent on average, or $444,000 annually. This is about $125,000 more than the floor Staff put on the necessary rate reduction, $315,000, in the August 2001 testimony of Staff witnesses concerning the temporary rates. OCA had not, before the Settlement was proffered, stated a floor on its likely request for rate reductions, but indicated that it would have been a larger rate reduction than the floor suggested by Staff.

The proposed allocation of the settlement rate reduction would give most of the benefit ($375,000) to the wholesale customers (access customers) and a small benefit ($65,000) to intrastate toll customers. Network exchange customers, whether business or residential, will see no rate reduction under the settlement agreement.

There are a number of concerns this settlement raises, with regard to whether interclass cost allocation is just and reasonable, whether the negotiated overall revenue reduction will be achieved given likely stimulus to intraLATA toll revenues from the rate reduction, and whether it is appropriate to allow the Company not to refund excess temporary rates.

With regard to interclass cost allocation, Staff witness Hart testified that, based on Staff's analysis, access customers were contributing excessively to the overearnings of the Company, and were accordingly entitled to the largest share of the rate reductions. In the testimony of Paul Keller, filed on August 8, 2001, Staff stated that access charges should be brought into line as much as possible with the "target July 1, 2001 NECA composite access rates," which are about 7 cents per minute of use (MOU). Staff asserted that reducing access charges in this fashion would bring access charges closer to their costs.

Witness Hart also made reference to RSA 378:17-a. By this statute, the Legislature encourages the Commission to reduce access charges in certain situations and with certain qualifications. Staff and the Company agreed, however, that RSA 378:17-a does not apply in the particular circumstances of this case, and that even if it did, the Legislature does not require

access charge reduction, but rather requires that the Commission "consider" access charge reduction.

The difficulty with Staff's analysis, based on an assumption that access charges for the Company are above costs, comes with the definition of "cost." Staff noted that access charge costs are thought to be “something close to a penny a minute.” Tr. p.41. If access costs were as low as a penny, and access charges were reduced to cost, Company revenue requirements grossed up for taxes would be reduced by over $500,000 for access charges alone.

However, there is reason to ask whether access costs may be considerably greater than one penny, if a fair allocation of joint and common loop and overhead costs were included in the calculation. That is, the penny per MOU estimate likely assumes no or only minimal contribution by access customers to joint and common costs. By contrast, most cost estimates for the typical cost of network exchange service (and intraLATA toll) typically do include a sizable contribution to joint and common cost responsibility. Had such a contribution responsibility been included in the assumed costs of access (with a corresponding reduction in the assumed costs of network exchange and intraLATA toll), it is possible that network exchange rates would have had to be reduced along with access and toll charges, in order to

fairly allocate the benefit of the overall Company revenue reduction.

Economists and analysts have debated extensively the proper basis for conducting a cost study for telephone companies. There is widespread agreement with the approach apparently followed in the estimates on which the parties relied in developing their Settlement Agreement. However, there is not universal agreement regarding this allocation of costs. For example, the economist William Melody proposed the so-called "stand-alone" method of cost allocation as long ago as the 1970's. The Maine Public Utilities Commission until recently had a method of pricing access for intrastate toll that was designed to achieve an equal contribution to joint and common costs from all customers, whether retail or wholesale. Under that approach, access rates were pegged to the retail price less the utility's long run cost of providing the service in question. That method has been overturned by the Maine Legislature, in favor of the approach encouraged by our own Legislature, that of reducing access charges, but this is a policy choice, rather than a choice dictated by economic theory.

Economists agree that there is no theoretically justified way to allocate joint and common costs between two products. Some economists do argue that it is economically

efficient to charge all or most telephone costs on the basis of flat rates, rather than time- or distance-sensitive minutes of use. Such an approach would tend to raise basic monthly rates, and allow all other rates to be lowered. First, this view says nothing about whether wholesale customers (access customers) are charged for their fair share of joint and common costs, but only counsels that any such costs be collected on a flat per line basis. Also, the choice of flat rates rather than traffic-sensitive rates is fundamentally a policy question, with a number of competing considerations, including fairness issues that counsel retention of a greater or lesser emphasis on traffic-sensitive pricing.

The Commission has not examined the theoretical and practical issues surrounding the allocation and pricing of joint and common costs to retail and wholesale customers in a systematic way since the passage of RSA 378:17-a. Because the matter before us today is a settlement, and in a case involving a relatively small telephone company, the record in this docket does not permit a meaningful determination as to the equitable allocation of such costs, and accordingly, does not provide a basis for determining the cost of access for this Company. To the extent, then, that the Commission may be open in a future case to the argument that a different allocation of costs is just

and reasonable and in the public interest, it has limited options in considering the settlement.

In particular, the Commission could reject the settlement, or approve it with the condition that the parties negotiate a different allocation of costs, which would likely result in the withdrawal of the settlement. Rejecting the settlement would also allow the Commission to examine more closely the possible stimulative effect on Company revenues of lowered toll rates, and would eliminate the agreement not to reduce rates retroactively to reconcile temporary and permanent rates.

It may also be that the Commission would determine after a litigated hearing that yet larger revenue reductions were warranted (although the settlement proposes reductions greater than the Staff estimate of a just and reasonable minimum revenue reduction). All these considerations represent opportunities, beyond the examination of cost allocations, that would be forgone by accepting the settlement. Rejecting the settlement, however, would have a number of adverse impacts.

First, it would again place the amount of revenue reduction in doubt, and likely lead to time-consuming and costly hearings. In this regard, we note that the Company here has

agreed not to seek recovery of approximately $45,000 in rate case expenses incurred to date if the settlement is approved.

Second, we cannot state with certainty that a litigated rate case would produce revenue requirement reductions equal to or greater than those estimated by Staff in its temporary rate case testimony.

Third, and significantly, it would be preferable not to place the entire burden of developing a record as to the cost allocation question onto a single company of this size. This is particularly the case since other interested parties, such as the interexchange carriers who pay access charges, or representatives of toll customers, have not participated in this docket. Thus, even a litigated proceeding will not necessarily enable the parties to develop a sufficient record to make the significant policy decisions raised by the cost allocation question.

Balancing these competing considerations, we find that the settlement is just and reasonable and in the public interest. We are satisfied that the revenue reductions stipulated by the parties closely enough approximate the outcome that might be expected in a litigated case. As to cost allocation, in addition to the observations above we note that while the Company's exchange revenues are just above the state median when weighted by the number of lines each exchange customer can reach, they are

below the median on an unweighted basis, and in any case are not so high that leaving them at their present level is *per se* unjust and unreasonable. We find that the potential fairness benefits to exchange customers in terms of possible cost allocation changes are outweighed by the certain additional costs involved in litigating this case to conclusion.

We note that the Company's earnings can be reevaluated at the end of next year, and if there is any reason to adjust rates at that time, it can be done. In addition, if before that time the Commission conducts a broader examination of the cost allocation issues raised today, the settlement does not preclude an adjustment of the class cost allocations and resulting rates if one is warranted.

Although other outcomes might well have been warranted by a different record, on balance we find that the settlement agreement is just and reasonable and in the public interest. Thus, we will accept the settlement agreement. We thank the parties for their work in producing this settlement for our consideration.

Based upon the foregoing, it is hereby

ORDERED, that the Settlement Agreement is APPROVED; and it is

FURTHER ORDERED, that the Company file revised tariff pages as presented with the Settlement no later than October 1, 2001.

FURTHER ORDERED, that the Company shall, with its October billings, notify customers of the optional intrastate toll calling plan as set forth in the Settlement Agreement.

By order of the Public Utilities Commission of New Hampshire this first day of October, 2001.

Douglas L. Patch Chairman	Susan S. Geiger Commissioner	Nancy Brockway Commissioner

Attested by:

Thomas B. Getz
Executive Director and Secretary