**DT 01-221**

**KEARSARGE TELEPHONE COMPANY**

**Petition for Approval of Alternative Form of Regulation**

**Order Following Hearings**

**O R D E R N O. 24,281**

**February 20, 2004**

**APPEARANCES:** Murray, Plumb & Murray by John C. Lightbody, Esq. for Kearsarge Telephone Company; Office of Consumer Advocate by F. Anne Ross, Esq. on behalf of residential ratepayers; and Donald M. Kreis, Esq. of the Staff of the New Hampshire Public Utilities Commission.

## I. PROCEDURAL HISTORY

On November 9, 2001, Kearsarge Telephone Company (KTC) filed with the New Hampshire Public Utilities Commission (Commission) a petition for an alternative form of regulation pursuant to RSA 374:3-a. This statute provides that, upon petition or on its own motion, the Commission may "approve alternative forms of regulation other than the traditional methods which are based upon cost of service, rate base and rate of return" as long as the alternative regulation yields "just and reasonable rates and provides the utility the opportunity to realize a reasonable return on its investment." KTC, a subsidiary of TDS Telecom, Inc. (TDS), is an incumbent local exchange carrier that provides service to customers in Boscawen, Chichester, Meriden, New London, Salisbury, Webster and Wilmot.

Pursuant to an Order of Notice issued on November 16, 2001, the Commission conducted a pre-hearing conference on February 1, 2002. Prior to the pre-hearing conference, the Office of Consumer Advocate (OCA) entered an appearance on behalf of residential ratepayers. There were no intervenors. In Order No. 23,925 (March 1, 2002), the Commission approved a procedural schedule that called for hearings in December 2002.

With regard to the merits of the case, the Commission ruled in Order No. 23,925 that in order to evaluate KTC's alternative regulation proposal it would be necessary "to ascertain the appropriate starting point" with respect to rates. Order No. 23,925, slip op at 6. Therefore, the Commission directed the parties and the Commission Staff (Staff) to conduct a rate case that would proceed within the docket, concurrently with the evaluation of the alternative regulation proposal, directing KTC to file the materials and documents listed in Puc 1604.01(a) (concerning contents of a rate case) by May 1, 2002.

The Company submitted a revised Alternative Regulation Plan on March 4, 2002. On May 6, 2002, the Commission granted KTC's request to extend to June 7, 2002 the deadline for the Company's rate case filing. On June 5, 2002, Staff proposed certain revisions to the procedural schedule, on behalf of Staff and the parties, and raised the issue of temporary rates under RSA 378:27, recommending that the Commission schedule a hearing

for that purpose. On June 14, 2002, the Commission approved a revised procedural schedule that contemplated hearings in January 2003. On June 17, 2002, KTC submitted a further revision to its Alternative Regulation Plan. On June 26, 2002, Staff submitted an assented-to motion for a hearing on temporary rates. KTC requested a four-week extension of certain deadlines on July 15, 2002.

The Commission issued an Order of Notice on July 24, 2002, scheduling a hearing on temporary rates for August 8, 2002. KTC thereafter sought a continuance and/or the opportunity to present witnesses by telephone, requests that were opposed by Staff. KTC filed a further revision to its Alternative Regulation plan on August 5, 2002. The Commission revised the procedural schedule on August 8, 2002 to provide for hearings on February 20 and 21, 2003. The Commission rescheduled the temporary rate hearing for August 28, 2002. On August 12, 2002, KTC submitted the pre-filed direct testimony of its witnesses Timothy W. Ulrich and Bryan D. Woltman.

The hearing on temporary rates took place as scheduled. Thereafter, the Commission issued Order No. 24,056 (September 19, 2002), fixing temporary rates for KTC under RSA 378:27 equal to the Company’s then-current rates. The temporary rates were made effective for service rendered on or after March 1, 2002.

On October 18, 2002, OCA submitted the pre-filed testimony of William Homeyer and Staff submitted the pre-filed testimony of Mary K. Hart and Chris M. Schlegel. On December 23, 2002, the Company submitted rebuttal testimony from Messrs. Ulrich and Woltman as well as Jeff D. Makholm. Thereafter, the parties and Staff met on several occasions for the purpose of conducting settlement discussions. Settlement was not reached.

On February 18, 2003, the Commission granted in part and denied in part a request by KTC with respect to how the Commission should hear the case. Specifically, the Commission decided that it would bifurcate the merits hearing in the proceeding – considering rate case issues first and, thereafter, taking up the substance of the Company's proposed alternative regulation plan. The Commission advised the parties that the two days of hearings in February would be confined to rate-related matters. These hearings took place as scheduled on February 20 and 21, 2003. On March 21, 2003, the Commission resolved an uncertainty that had arisen at hearing by ruling that only those exhibits actually referenced at the hearings (as opposed to exhibits pre-marked by the parties but not referenced) would be admitted into evidence. KTC and OCA submitted written briefs on the rate-related issues on April 8, 2003.

The Commission conducted hearings on May 13 and 14, 2003 to receive evidence with respect to KTC's proposed alternative regulation plan. At the hearing on May 13, the OCA moved to reopen the record with respect to the rate-related issues in light of what the OCA characterized as newly discovered evidence. At issue was a "cash management fund" of approximately $10 million, maintained on KTC's books. According to OCA, the cash flow statement in the Company's 2002 annual report marked the first time this fund was identified as a cash equivalent. Staff had no objection to OCA's request to reopen the record, which KTC opposed.

OCA made an offer of proof with respect to its motion at hearing on May 14. At that time, the Commission granted the OCA motion, at least insofar as the Commission (1) noted that a third day of hearings would be necessary with respect to the proposed alternative regulation plan, (2) scheduled such a hearing for June 12, 2003, and (3) instructed the parties and Staff to confer with respect to the substance of the OCA motion and present any necessary evidence to the Commission on June 12.

On May 15, 2003, Staff filed a letter indicating that it had agreed with KTC and OCA to propose that certain additional discovery take place with respect to the cash management fund and that, thereafter, OCA and Staff have an opportunity to file supplemental direct testimony by May 21,

2003, with responsive testimony from KTC by May 30, 2003. OCA made such a filing as scheduled and, with leave of the Commission, KTC submitted rebuttal testimony on June 2.

The final day of hearings took place as scheduled on June 12, 2003. KTC submitted responses to certain record requests on June 18, 2003. As directed by the Commission at hearing, the parties and Staff filed briefs on June 18, 2003; KTC submitted a reply brief on July 30, 2003.

On January 23, 2004, the Commission received a letter from John C. Lightbody, containing supplemental information regarding the amount of bad debt resulting from the WorldCom and Global Crossing bankruptcies. The information updates KTC’s bad debt adjustments, in the record, for the 2001 test year.

## II. POSITIONS OF THE PARTIES AND STAFF

As described above, the record of this case is divided into three distinct portions, each with associated arguments of the parties: (1) issues related to the setting of new rates for KTC, based on traditional rate-of-return regulation principles, (2) issues related to the KTC cash management fund and whether its existence or treatment should affect the Company’s rates as they would otherwise be set here, and (3) the proposed alternative regulation plan. We summarize the positions of the parties and Staff as to each of these issues separately, and then discuss them at the conclusion of our order.

**A. Rate Issues**

As noted by the parties at hearing, there are only three contested issues in connection with KTC's rate case filing. In all other respects, the parties and Staff are in agreement that the Commission should adopt KTC's proposal. The issues in dispute concern (1) recovery by KTC of expenses associated with bad debts owed to KTC by two toll carriers, WorldCom and Global Crossing, both of whom have sought bankruptcy protection, (2) whether the Commission should impute to KTC a capital structure of 50 percent debt and 50 percent equity, as opposed to the Company's actual capital structure of 15 percent debt and 85 percent equity, and (3) whether the 15.09 percent cost of equity reflected in KTC's rate filing is reasonable.

**1. Kearsarge Telephone Company**

KTC noted that, at the time of the Global Crossing and WorldCom bankruptcy filings, the two interexchange companies (IXCs) owed a total of $102,045 to KTC. According to KTC, these bad debts reflected known and measurable changes to the Company's test year revenues and therefore should be included as adjustments to such revenues. KTC contended this is so because (1) these bad debts represent a new type of business risk not previously faced by independent telephone companies like KTC, (2) the amounts involved are more than ten times KTC's average

bad debt for the past four years, and (3) the bad debt otherwise included in KTC's test year consists of funds owed by retail customers, as opposed to IXCs.

In KTC's view, the Commission can and should recognize this new business risk for ratemaking purposes by either (1) adding a normalized amount to KTC's revenue requirement, (2) imposing a temporary surcharge on KTC's intrastate access rates to allow recovery of this amount, or (3) reducing any refund from KTC's overearnings (based on the previously established temporary rates) by the amount of the loss. With respect to normalization, KTC urged the addition of $34,015 (one-third of the debts in question) to the revenue requirement to reflect a determination that these types of problems are likely to arise once every three years for major telephone carriers.

KTC disagreed with OCA's suggestion that the Company should have protected itself against these losses, noting that the debts were current (and thus not subject to disconnection or other collection-related remedies) at the time of the bankruptcy filings. KTC further posited that any future recovery of these debts could be refunded to customers without precluding the adjustment the Company proposes now. Finally, KTC argued that if the Commission finds that KTC is overearning, intrastate access rates (as opposed to its local rates) should be reduced. If the Commission determines access rates should be reduced and

temporary rates should be refunded to Interexchange Carriers (IXCs), KTC recommends the amount of the refund be offset by the amount of bad debt. This, according to KTC, is an equitable solution because the IXCs will be paying for the additional expense caused by changes in the IXC competitive market and the failure of two IXCs.

KTC urged the Commission to employ the Company's actual capital structure (85 percent equity and 15 percent debt) in determining the cost of capital to be applied to rates. According to KTC, an appropriate capital structure is an area of management discretion that should be left to each telephone utility in determining how to utilize its resources to provide quality, reliable service. It is KTC's contention that a key exercise of that discretion here involves maintenance of an A minus credit rating. KTC conceded it is a relatively small portion of the TDS corporate family and will, therefore, have little effect on the overall TDS credit rating. KTC nevertheless suggested that imputing a hypothetical capital structure would be tantamount to regulating the Company on the assumption that other jurisdictions will allow other TDS affiliates to employ their actual capital structures.

In the alternative, KTC contends that if the Commission decides to impute a capital structure to the Company, a figure of 75 percent should be used for equity. According to

KTC, this is the average equity position of New Hampshire independent telephone companies other than KTC. Further, according to KTC, any decision to impute a capital structure to KTC should be applied prospectively only. In KTC's view, such a decision would amount to a major policy change and, thus, it would be unfair to make such a change retroactive to March 1, 2002 (the effective date of the temporary rates in this docket). KTC suggested setting a revenue requirement for an initial three-year period based on the current capital structure, to allow the Company to transition to the capital structure desired by the Commission.

Finally, KTC argued that if the Company is required to shift any of its present equity to debt, the additional debt should bear the Company's current cost of borrowing (a minimum of 7.5 percent), as opposed to KTC's historic cost of borrowing (averaging 6.2 percent). Assuming KTC's actual capital structure is used, KTC argued that its actual cost of debt from existing issues should be utilized for long term debt. Exh. KTC-2 p 10.

With respect to return on equity, KTC urged the Commission to adopt 15.09 percent. According to KTC, this figure is derived from the use of the standard Discounted Cash Flow (DCF) analysis employing a proxy group of five comparable companies. KTC further maintained that it should be allowed

issuance costs, there should be an adjustment to reflect overstatement of observed stock prices because of approaching dividend payments (the so-called ex-dividend adjustment) and the Commission should reject the DCF analysis of Staff witness Chris Schlegel as inconsistent with precedent.

With respect to Mr. Schlegel's DCF analysis, KTC contended that (1) the use of historical weighting in the DCF analysis is inappropriate because historical data is already reflected in the ValueLine data that forms the model's inputs, (2) Mr. Schlegel's dividend growth projections do not take into account the effect that telephone companies are presently retaining more of their earnings to improve their financial positions, (3) Mr. Schlegel should not have used a three-stage DCF model, (4) Mr. Schlegel incorrectly contends that KTC's return on equity should be low because interest rates are generally low throughout the economy, and (5) that even assuming Mr. Schlegel's methodologies are correct they should result in a return on equity of 13.20 percent. KTC further pointed out that in Docket No. DT 02-110, which concerns the cost of capital of Verizon New Hampshire, the OCA's expert witness made several recommendations that KTC contends conflict with Mr. Schlegel's recommendations here.

KTC requested that the Commission defer its decision on rates to its consideration of all issues in this case.

According to KTC, this would maximize the Commission's flexibility with respect to designing an appropriate alternative regulation plan for the Company. According to KTC, deferring a decision on rates would not harm ratepayers because they are adequately protected by temporary rates which will be reconciled in the event the Commission determines the Company has been over-earning.

**2. Office of Consumer Advocate**

OCA contended that KTC's receivables arising out of the Global Crossing and WorldCom bankruptcy proceedings should not be treated as bad debts or trigger any adjustment to test-year revenues. According to OCA, two facts emerged at the hearings in May that are relevant: the fact that KTC had been negotiating a settlement of its claims against the two bankruptcy debtors and the fact that KTC has accounts payable that it owes to WorldCom that KTC is claiming as an offset against the unpaid receivables. In OCA's view, the debts in question are not currently known and measurable (given the ongoing bankruptcy proceedings and attendant corporate reorganizations, which could result in at least a partial payout of the amounts owed KTC). At the very least, according to OCA, the offset amounts disclosed at hearing should be deducted from the debt amounts.

OCA further asserted that the record does not support KTC's contention that it faces additional risk of bad debts similar to those owed by Global Crossing and WorldCom. According to OCA, only three other carriers had monthly accounts payable in excess of $25,000, and these entities are not in danger of seeking bankruptcy protection. OCA also pointed out that the test year for this case is 2001, whereas the debts in question were incurred in 2002. According to OCA, since the amount of the loss cannot be fixed with certainty, it would be inappropriate to make any adjustment to test-year revenues.

OCA supported Staff's proposal to impute a capital structure to KTC consisting of 50 percent debt and 50 percent equity. According to OCA, in *New England Telephone Co. v. State*, 98 N.H. 211 (1953), the New Hampshire Supreme Court affirmed a Commission determination that a 45-55 percent debt/equity ratio is appropriate for a telephone company, noting that the Commission can "legally determine a just and reasonable rate of return upon a capital structure different from the actual structure of the company at the time the case was adjudicated." *Id.* at 220.

OCA pointed out that Staff's recommendation with respect to imputing a capital structure to KTC does not require the Company to make actual changes to its capitalization. According to OCA, if KTC wishes over time to change its actual

capital structure to conform to the structure that the Commission can and should impute here, the Company is free to do so – but it must take that action in a manner that does not disrupt or damage the utility's business or financial integrity.

OCA supported Staff's recommended 8.892 percent cost of equity, as opposed to the 15.09 percent proposed by KTC. According to OCA, the determination requires the Commission to choose among the views of the three experts who testified on the subject: Mr. Schlegel, Mr. Woltman (who provided KTC's initial recommendations) or Mr. Makholm (who critiqued Mr. Schlegel's approach and arrived at a cost of equity of 13.20 percent).

OCA invoked the Commission's plenary ratemaking powers under RSA 378:7 in suggesting that the Commission not defer consideration of rate-related issues to its determination with respect to KTC's proposed alternative regulation plan. According to OCA, the inquiries are fundamentally independent of one another and should be decided separately.

OCA disagreed with Staff's recommendation to apply any over-earnings determined here to a reduction in intrastate access charges to IXCs. According to OCA, it is more appropriate to reduce basic rates, given the lack of correlation between the intrastate access rates charged to IXCs and the intrastate long distance rates actually paid by the customers of the IXCs.

According to OCA, a mainstay of Mr. Woltman's testimony was his contention that KTC is facing increasing competition and risk. Yet, OCA contended, KTC failed to produce any evidence that it has lost even a single local customer to a land-line competitor. OCA points out that KTC has never received a request for interconnection under 47 U.S.C. § 251(f) (which would trigger Commission proceedings with respect to KTC's exemption as a rural telephone company from the obligation to interconnect with competitive telecommunications carriers) and still enjoyed an exclusive utility franchise under RSA 374:22-f. OCA noted that KTC has offered to waive its exclusive franchise as a matter of state law as a part of its alternative regulation proposal, but points out that such a plan has not yet been put into effect. OCA also noted that KTC has not demonstrated any significant line loss in its service territory over the past five to ten years.

According to OCA, given that KTC has admitted it is at a lower risk than other telecommunications utilities operating in larger urban areas, it has no basis to request a higher rate of return than the average 11.15 percent return on equity proposed by OCA's expert witnesses in the Verizon cost of capital proceeding, Docket No. DT 02-110. OCA also pointed out that KTC's requested cost of equity here is considerably higher

than the 10.77 percent return on equity approved by the Commission the last time KTC litigated the issue.

**3. Staff**

Staff noted that KTC's current capital structure consists of 84.63 percent common equity and 15.37 percent debt. Staff witness Schlegel characterized this as unusual, noting that as of June 2002, telecommunications carriers with Moody's ratings at investment grade or higher had, on average, a capital structure consisting roughly of debt and equity in equal parts. Such a structure, according to Mr. Schlegel, is one that preserves the financial soundness of the company.

Staff proposed that the Company's reported 6.24% cost of debt should be used in calculating the Company's weighted average cost of capital. Staff pointed out that the Company continues to utilize low cost debt financing, and that therefore KTC's actual cost of debt remains in a range that is reasonable.

Mr. Schlegel noted that, because KTC is a subsidiary of a parent firm and thus not a publicly traded company, it was necessary to use a proxy group of publicly traded companies to develop an estimate of KTC's cost of equity. Staff used the same five proxy companies as KTC did, but noted that it considered these companies to have a higher degree of risk (and thus a higher cost of capital) than KTC. Thus, according to

Staff, the data from the proxy companies should produce cost-of-equity results that are conservatively high with respect to KTC.

Staff took the data from the proxy firms (current annual dividend, current stock price and growth rates) and derived a proposed cost of equity using the discounted cash flow (DCF) model. However, Mr. Schlegel proposed a modification of the traditional DCF model. According to Mr. Schlegel, the DCF model as it has applied in the past assumes that the company in question can sustain its growth rate indefinitely – which, according to Mr. Schlegel, results in the "firm being compensated for rewarding investors with growth so large that it eventually produces a telecommunications carrier equal to the size of the economy." Staff Exh. 1 at 16.

Therefore, Staff proposed the use of a "3-stage" version of the DCF model that employs the usual growth rate to estimate the discounted cash flow only for the first five years. This model posits a "Stage 3" or long-term growth rate pegged at the annual long-run sustainable growth rate of the economy's nominal output, set at 5.5 percent (the sum of real output growth of 3.5 percent and inflation of 2 percent). Under this model, "Stage 2" is simply a transitional growth rate that allows for a smooth transition from the "Stage 1" to the "Stage 3" growth rate. According to Mr. Schlegel, using the three-stage DCF model yields a cost of equity for KTC of 8.89 percent,

29 basis points higher than that which the standard DCF model would predict. According to Mr. Schlegel, this is reasonable, based on checking these results using other calculation methods (risk premium method, Ibbotson's Full Information Beta method and general market observations). This yields a weighted average cost of capital of 7.565 percent, based on imputing a capital structure to KTC of debt and equity in equal parts.

Staff witness Mary Hart additionally proposed certain *pro forma* adjustments to the Company's revenue requirement. The Company agreed to most but not all of these adjustments. The remaining dispute involved KTC's plan to amortize $102,045 over three years to reflect uncollected access charges arising out of the Global Crossing and WorldCom bankruptcies. According to Staff, this would have the effect of improperly building $34,015 into the company's annual revenue requirement for a non-recurring expense.

**B. Issues Related to the Cash Management Fund**

**1. Office of Consumer Advocate**

OCA addressed two issues with respect to KTC's cash management fund. First, OCA contended KTC should not be permitted to include $10,124,778 of temporary investments in common equity for the purpose of calculating the Company's cost of capital. According to OCA, by accumulating these earnings, retaining them and then including them in its cost-of-capital

computation, KTC is effectively charging its customers a second time on these earnings. OCA further pointed out that the interest income KTC received on these investments was included by the Company as non-operating income, thus providing no benefit to ratepayers.

OCA further took the position that the existence of these temporary investments in KTC's capital structure is further evidence that a capital structure should be imputed to the Company that includes less equity than the 85 percent proposed by KTC. It is also OCA's view that the existence of these temporary investments undercuts KTC's expressed view that it should be allowed a phase-in period should the Commission deem its debt/equity ratio to be improvident.

OCA proposed three possible resolutions of this issue: (1) eliminate the temporary investments from the company's capital structure, (2) require the Company to include a portion of the interest income earned on these investments as "above the line" income for ratemaking purposes, or (3) adopt Staff's proposal to impute a capital structure to the company of half debt and half equity.

In general, according to OCA, a regulated utility should not be permitted to allow its capital to exceed its rate base. OCA urged the Commission to compare rate base to capital each time it reviews a utility's annual report. According to

the OCA, because KTC's investment in the Telecom Technologies Fund, LLC (TTF) is not used and useful in connection with its provision of utility service, it should be excluded from the Company's capital structure for ratemaking purposes.

The second issue addressed by OCA concerns what it characterizes as erroneous reporting by KTC on its annual reports for 1999, 2000 and 2001. According to OCA, these errors involve the Company's failure to report correctly the cash and cash-equivalent balances on the cash-flow statements included in the annual reports. OCA asked the Commission to impose fines on the Company pursuant to RSA 374:17, to require annual reports henceforth to include descriptive footnotes describing affiliate transactions, and to develop a computerized financial reporting history for each utility to facilitate the analysis of financial trends.

**2. Kearsarge Telephone Company**

It is the position of KTC that OCA's allegations relating to the cash management fund are unfounded. According to the Company, it has consistently submitted all required financial reports in good faith, with no intent to hide or deceive anyone. In the supplemental testimony submitted by KTC witness Bryan D. Woltman, there is a reference to "minor discrepancies and minor inadvertent errors" that were the result of interpretations made by the Company's accountants of the

schedules on the Commission's annual report forms for years prior to 2002. KTC Exh. 71 at 6. According to KTC, when the Commission's annual report form was automated, in connection with reports relating to calendar year 2002, the cash management fund automatically received the treatment that OCA asserts is the correct one.

According to Mr. Woltman, the retained earnings in question are investments made by KTC in an affiliate, Telecom Technologies Fund, which "functions as a cash management cooperative fund by pooling the cash temporarily available to various TDS subsidiaries and lending funds to other TDS subsidiaries." *Id.* at 9. KTC noted that the arrangement had been explicitly approved by the Commission in 1989, and took the position that the extent of KTC's investment in TTF was fully disclosed to the Commission and the OCA.

Mr. Woltman noted that paying out the TTF investment as a dividend would alter KTC's capital structure to make it approximately 70 percent equity. He contended that if the Commission accepted Staff's recommendation with respect to capital structure, the TTF funds would be insufficient to reduce the Company's equity and additional borrowing would be necessary.

In his testimony, Mr. Woltman stressed that KTC has made no attempt to mislead the Commission with respect to its

TTF investment. He noted that the Company's temporary cash investments were not included in its proposed intrastate rate base, had no effect on the Company's intrastate rate base, and the Company was not seeking to receive a return on this investment from New Hampshire ratepayers in connection with this proceeding. Mr. Woltman testified that no basis exists for the OCA's suggestion that interest income derived from the TTF investment be included in KTC's revenue for purposes of setting rates here.

According to Mr. Woltman, the term of certain loans KTC obtained from the Rural Electrification Administration and Rural Telephone Bank exceed the depreciable life of the property financed through the loans. Thus, Mr. Woltman testified, the Company has received cash from depreciation of this property sooner than the applicable loan payments were due. Thus, according to Mr. Woltman, a textbook treatment of the TTF investment for capital structure purposes would involve using some $2.6 million to reduce loan balances, plus allocating approximately $940,000 to deferred income tax liability and using the remainder to reduce equity. Mr. Woltman testified that if the Company took these steps, it would actually increase KTC's equity in the capital structure to 95 percent and "cause greater underearnings than originally reported by the Company in its previously filed testimony." *Id.* at 19.

Mr. Woltman attributed the erroneous annual reports identified by OCA as chiefly the result of an interpretation by KTC's accountants, prior to the 2002 annual report, that the cash balance reported on Schedule B-16 should agree with the balance reported on Schedule B-10 in Account 1130 (as opposed to the cash balance reported by the Company's external auditors). According to Mr. Woltman, the Company began reporting its TTF investment on Schedule B-16 as of the 2002 annual report because the Commission's newly established electronic reporting system caused this to happen automatically.

The Company, through Mr. Woltman's testimony as well as the argument of counsel, took exception to OCA's suggestion that fines be imposed with respect to the erroneous annual reports. According to KTC, the statute invoked by OCA is inapplicable because it concerns only the failure to file annual reports as opposed to the submission of reports with errors. Further, according to KTC, any errors were either mistakes in accounting interpretations or minor typographical errors. KTC asserts that at no time did it attempt to hide its TTF investment, which was always reported on schedules B-10 and B-17 of its annual report even when missing from schedule B-16.

**3. Staff**

Staff's position with respect to the TTF investment is that its existence bolsters the arguments in favor of Staff's

imputed capital structure of 50 percent equity and 50 percent debt.

**C. Alternative Regulation Plan**

**1. Kearsarge Telephone Company**

The most recent edition of the KTC Alternative Regulation Plan, and the one KTC urges the Commission to adopt here, appears in the record as Exhibit KTC 45. It bears a date of December 20, 2002. The plan's major components can be summarized as follows:

The plan calls for an effective date of July 30, 2003, unless KTC withdraws its request for alternative regulation within 30 days of the issuance of the Commission's final order in the docket. The plan would be effective until either the Commission or KTC terminates it pursuant to Puc 206.09. KTC would be required to submit a report to the Commission analyzing the plan's effectiveness within five years of its implementation date.

For purposes of the alternative regulation plan, KTC's basic local services would be "those services that provision a one-party access line to a residential or business customer," with non-basic local services comprising all other local exchange services except switched access services and not included in a specified list of competitive services. Exh. KTC 45 at 2. "Competitive services" are "services for which

competition or the potential for competition in the marketplace is or can be an effective regulator of the price for those services." Id. at 3. Initially, directory assistance, voicemail and speed dialing would be so classified.

Upon the effective date of the plan, KTC's rates for all classes of services would be the rates determined by the Commission in the rate-case portion of this proceeding. Thereafter, rates for basic local services would be frozen until July 1, 2005, except for any "exogenous changes." These adjustments result from "a change in any government mandate, rule, regulation or statute which causes a net reduction in a local exchange carrier's total intrastate regulated revenue, expenses, or plant in service, of more than 1% in any twelve-month period." Id. at 8-9.

Beginning on July 1, 2005, and on every July 1 thereafter, KTC's rate for basic local service would change based on the Gross Domestic Product Price Index, plus or minus a specified "Infrastructure Investment Component," plus or minus a specified "Service Quality Component." Id. at 4.

The Infrastructure Investment Component compares KTC's capital expenditures during the prior year to a five-year rolling average of such expenditures. This component ranges from a one percent penalty if current capital expenditures are more than ten percent below the rolling average to a one percent

incentive increase if capital expenditures are similarly ten percent in excess of the rolling average.

The Service Quality Component would be somewhat more complicated to calculate. It is based on industry-wide averages for six quality standards: average days between date of request for service and installation, percentage of missed installment commitments, annual regulated trouble reports per 100 lines, percent repeat regulated trouble reports, percentage of service outages over 24 hours, and length of repair time. Each factor would have a weight of -0.5 percent, 0.0 percent or 0.5 percent, with the maximum annual service quality penalty or incentive at 3 percent.

The KTC proposal contemplates an annual filing by March 1 of each year, 60 days of review by the Commission and a limitation of one rate increase per service per year. The plan also provides that KTC may defer and accumulate any annual price increase for up to three years. KTC would be permitted to bundle any basic local service with any other regulated or non-regulated service, in which case such bundle would be priced and regulated as a non-basic local service. Likewise, KTC would be permitted to adopt any new rate structure, such as flat rate service or local measured service, for any basic local service so long as the rate was above cost and the Company continues to offer the preexisting rate structure as well. Services under

such new rate structure would be priced and regulated as a non-basic local service.

The proposal would freeze prices for non-basic local services for one year, except for exogenous changes as described above. Thereafter, the Company would be free to increase prices for such services at its discretion, but the aggregate amount of revenue generated from such changes could not be more than six percent of total annual revenues from non-basic local services during the applicable 12-month period. KTC would be permitted to decrease the price of any non-basic local service so long as the rate is not below the Total Element Long Run Incremental Cost (TELRIC) of providing the service. Competitive services would be completely deregulated.

As a part of the plan, KTC would commit to improving its network infrastructure, regularly assessing customer satisfaction and funding capital construction. It would continue to meet the service quality reporting requirements of Puc 1308.04 and would continue to report its proposed expenditures for additions, extensions and capital improvements.

The plan calls for KTC to waive the exclusivity of its state-law utility franchise pursuant to RSA 374:22-f. However, the Company reserves all its rights under the federal Telecommunications Act, including the rural exemption from interconnection obligations set forth in section 251(f) of the

statute. KTC agreed that it would file a wholesale price list within six months of the effective date of the plan, describing the retail telecommunications services it will offer for resale. Applicable rates would be based on retail services provided to end-user customers, less costs that can actually be avoided with respect to services ordinarily sold at retail.

In requesting that the Commission approve its proposed alternative regulation plan, KTC avers that the main policy goal of the plan is to permit the Company to "adjust and transition to a market moving toward competition." KTC Brief at 3. According to KTC, traditional regulation based on cost of service and allowed rate of return is inadequate to this task because it provides little incentive for utilities to control costs or increase revenues. Further, according to KTC, traditional regulation limits incentives for innovation, is expensive and administratively burdensome, causes inefficient choices of operating technology and provides inadequate flexibility in the presence of competitive pressures.

KTC seeks to distinguish the circumstances of the instant case from those underlying the Commission's decision in *New England Telephone & Telegraph Co*., 76 NH PUC 393 (1991). In the *New England Telephone* case, the Commission rejected a proposal by an incumbent local exchange carrier (ILEC) for an alternative regulation plan. According to KTC, circumstances

have changed significantly since 1991, in a manner that justifies a different outcome here. The changes cited by KTC include: the enactment of RSA 374:3-a (explicitly authorizing the Commission to approve alternative forms of regulation); the adoption by the Commission of Puc 206 (describing procedures and standards applicable to petitions for alternative form of regulation); the enactment by Congress of the Telecommunications Act of 1996; the issuance by the Federal Communications Commission (FCC) of numerous orders implementing the Telecommunications Act; the issuance of numerous court orders interpreting the Telecommunications Act; the substantial growth of competitive local exchange carriers (CLECs) in New Hampshire; proceedings before this and other state utility commissions related to interconnection between CLECs and ILECs as well as questions related to the offering by ILECS of unbundled network elements (UNEs); and technological changes, viz: the development of wireless networks, the expansion of cable TV and the expansion of high-speed cable TV networks, the dramatic growth of internet service providers other than telephone companies, the development of such new services as voice-over-internet and the transmission of voice over electric wires, and the expansion of cable TV companies into local exchange telephone business. KTC also points to the growth of inter-exchange carriers (IXCs) (i.e., long-distance companies) brought

about in part by reductions in access rates and resulting in IXCs offering integrated packages that include local service, the development of a substantial body of regulatory experience in other jurisdictions with alternative regulation plans and what KTC characterizes as a substantial expansion and change in consumer expectations about the nature of telephone service and types of telephone companies providing local telephone service.

It is KTC's position that telephone competition exists today in its service territory and cannot be stopped. According to KTC, this developing competition is the reverse of that which has been experienced by the Regional Bell Operating Companies (RBOCs) in the sense that alternative providers are competing largely for residential customers as opposed to business customers. Conceding that there are "still dead spots and call drops" in the KTC service territory, KTC nevertheless points to the growth of wireless telephone service in the area. KTC Brief at 7. KTC further asserts that the growth of the internet and alternative internet providers is driving down measured minutes of use from access and increasing the percentage of time for local usage. According to KTC, an increasing number of users are simply dropping off the network and relying on voice-over-internet or other substitutes. Thus, KTC asserts, the company has suffered an actual decline in both the number of access lines and in the minutes of access use.

KTC contends that its proposal solves a "chicken and egg" problem -- i.e., the question of whether significant wireline competition for business customers or the approval of alternative regulation plan must come first. In KTC's view, the existence of such competition is not a prerequisite to approval of its plan, and such approval will trigger such competition by waiving the Company's exclusive utility franchise under state law.

According to KTC, its proposal meets the standard for approval set forth in RSA 374-:3-a, which provides that the Commission may approve alternative forms of regulation other than the method (based on traditional cost-of-service, rate base and rate of return) if such alternative "results in just and reasonable rates and provides the utility the opportunity to realize a reasonable return on its investment." According to KTC, the rate-case portion of this proceeding will assure that the rates will be just and reasonable as an initial matter, a condition that will persist in light of an initial rate freeze, an ensuing period of rate changes limited by specific formulas and the existence of ongoing Commission review.

KTC further asserts that its proposal meets the conditions set forth in the applicable rule, Puc 207.07. The rule provides that the Commission shall approve an alternative form of regulation if it determines that such alternative

> (1) [r]esults in rates that are not unduly discriminatory and are at a level that allows those to whom a service is being marketed to obtain such service;
>
> (2) [p]rovides the utility the opportunity to realize a return on its investment which falls within a range that is neither confiscatory nor unduly profitable that reflects the utility's investment risk; and
>
> (3) [s]erves the public interest in light of the considerations described in Puc 206.06(b)(1) through (9).

The factors enumerated in Puc 206.06(b), in turn, include (1) competition, (2) the safety, adequacy and reliability of public utility service, (3) the "traditional regulatory balance" among utility shareholders, ratepayers and "other stakeholders," (4) administrative efficiency from the standpoint of both the utility and the Commission, (5) economic development in New Hampshire, (6) universal service, (7) innovation of services, (8) infrastructure improvements and (9) "[e]nvironmental and conservation safeguards and incentives."

According to KTC, its rates will not be unduly discriminatory and will be affordable, given that they are comparable to the rates charged by Verizon as well as other independent telephone companies in New Hampshire. The Company believes the rate-case portion of the proceeding assures the existence of a reasonable opportunity to receive a return on its investment, and points to the requirement in the proposed

alternative regulation plan that the Company report annually on the rate of return it actually realizes under the plan.

With regard to the nine factors enumerated in Puc 206.06(b), KTC contends that it need not show that its alternative regulation plan would be positive as to each factor. Rather, according to KTC, Puc 206.06(b) requires the Commission to consider all of the factors collectively in determining whether the proposal is consistent with the public interest. With regard to the specifics of the factors, KTC contends that the plan would promote competition by waiving state franchise protection and incenting the company to behave more like a firm in an unregulated market. With regard to service quality, KTC contends that its commitments in that regard "should remain unabated," with the new pricing mechanism serving as a "catalyst" to service quality. KTC Brief at 12-13.

KTC concedes that its alternative regulation plan would change the balance among consumers, stockholders and other stakeholders, but it contends that such changes will not unfairly benefit or harm any of these groups. The Company views administrative efficiency as a neutral factor initially, but takes the position that over the long term there will be efficiency gains as the Company, the Commission and other interested parties gain experience with alternative regulation and the required reporting. KTC contends that its proposal will

promote economic development by opening its service territory to facility-based competition, providing more flexibility for the Company and assuring that KTC will maintain high-quality infrastructure. The Company contends that its commitment to universal service, infrastructure improvements and environmental safeguards will remain unchanged, and that the plan will provide the Company with sufficient flexibility to introduce innovative services.

According to KTC, there are only three issues in dispute with respect to its proposal: whether any alternative regulation plan should be approved, what pricing mechanism should be employed for basic services, and the treatment of the federal rural exemption. In KTC's view, the first question requires the Commission to decide whether it is willing to use alternative regulation to advance public policy goals.

With regard to the pricing mechanism, KTC disagrees with Staff's insistence upon a productivity offset, or "X Factor," designed to share any productivity-related gains between the Company and its customers. According to KTC, the record in other states demonstrates that telephone companies respond to such X Factors by cutting costs through layoffs and service quality reductions. Finally, with regard to the federal rural exemption, KTC contends that maintaining the status quo merely allows the Commission to ensure that the public interest

is served in the event that another company desires to enter the KTC service territory. According to KTC, if the Commission required KTC to waive its rural exemption the Commission would be relinquishing its own authority to assure that the public interest is served.

In reply to arguments made by the OCA and Staff, the Company points out that the Commission would retain significant oversight and control over KTC under the alternative regulation plan. In that respect, KTC stresses that the Commission would retain the right to terminate the alternative regulation plan if any of the approval standards are no longer satisfied (e.g., because rates were no longer just and reasonable). The Company also points out that it would still be required to file the same reports and data it presently submits, plus additional information.

KTC characterizes as arbitrary and inappropriate Staff's view that an X Factor of 2.5 percent would be a vital component of any alternative regulation plan. By comparison, according to KTC, the actual and forecast Gross Domestic Producer Price Index (GDPPI) has averaged 1.95 percent over the 20 year period from 1994 through 2013.

Finally, KTC argues in reply that there is no requirement that it show traditional regulation does not work in order for the Company to gain approval of its alternative

regulation plan. And, in particular, the Company disputes Staff's suggestion that the existence of facility-based competition in the KTC service territory is a condition precedent to alternative regulation.

2. **Office of Consumer Advocate**

The OCA contends the Commission cannot approve the proposed alternative regulation plan because it fails to meet the standard set forth in RSA 374:3-a.

Specifically, the OCA takes the position that the KTC proposal fails to allow the Commission to ensure just and reasonable rates. Conceding that the plan allows for rate decreases, the OCA takes the position that the plan fails to create any realistic downward pressure on either basic or non-basic local rates. In that regard, OCA points out that the record reflects that there have been no such rate decreases with respect to any of the KTC affiliates in other states that have been placed on alternative regulation plans. Rather, according to the OCA, rates have increased in a number of those instances with the full impact falling upon residential as opposed to business customers.

The OCA draws the Commission's attention to the fact that in 1995 and again in 1999 the Commission determined that KTC (or its corporate predecessors) were over-earning and required a rate reduction pursuant to the traditional cost-of-

service methodology. According to the OCA, this should cause the Commission to infer that such a trend would continue in the absence of an alternative regulation plan. Thus, in OCA's view, KTC is likely to be overcompensated under alternative regulation in the absence of a mechanism for sharing productivity gains as proposed by Staff. Meanwhile, according to OCA, the record is devoid of hard evidence with respect to competition that would act as a check on rate increases. OCA avers that the only record evidence of competition relates to the loss of eleven customers to wireless competitors.

OCA objects in particular to the provisions in the plan that would convert basic service to the category of non-basic if it were bundled with any other service offered by the Company. In OCA's view, this is likely to result in a significant portion of the Company's revenue being subject to the shorter one-year rate freeze applicable to non-basic services and thereafter to less stringent limits than that which applies to basic services. The OCA contends that the plan would allow KTC to use bundling and selective rate increases for non-basic services to unfairly maximize revenue and cause customers to purchase bundled services that they would not ordinarily take.

According to the OCA, the ability to bundle basic services with non-regulated services would create oversight

problems for the Commission. In the OCA's view, the Commission would have a difficult time in these circumstances determining how expenses, capital assets and revenues should be allocated among the applicable services. Therefore, according to OCA, the Commission would be unable to determine whether regulated services are subsidizing unregulated ones.

The OCA characterizes the infrastructure investment and service quality provisions of the proposed alternative regulation plan as extremely weak. According to the OCA, KTC's investment in infrastructure has been declining on a per-access-line basis for ten years and will continue to do so given the budget projections in the record. OCA sees two problems: (1) such a trend suggests that KTC's rates should be decreasing under the standard methodology, and (2) during the two-year freeze in basic rates under the alternative regulation plan, KTC has every incentive to allow infrastructure investment to plummet so as to lower the rolling five-year average that would apply to the relevant incentive mechanism in the future. With respect to service quality, the OCA points out that in order to avoid the applicable penalty, KTC can actually allow its service quality to degrade from present levels.

**3. Staff**

Staff urges the Commission to reject KTC's proposed alternative regulation plan, in favor of simply implementing the

new rates supported by the earlier phase of this proceeding and continuing to regulate the Company based on the traditional ratemaking methodology.

In the view of Staff, the alternative regulation plan advanced by KTC here is no more beneficial to the public than the one rejected by the Commission in its 1991 *New England Telephone* decision. According to Staff, the Company has pointed to no specific services, technological solutions or operational changes that would emerge in the wake of approval of the plan. Staff further asserts that the Company projects a declining level of capital expenditures from 2003 through 2006.

Staff contends that KTC has provided no empirical support for the superiority of alternative regulation as compared to the traditional methodology. Nor has the Company demonstrated that traditional regulation has unduly prevented KTC from innovating or making investments under rate-of-return regulation, according to Staff.

In Staff's view, the KTC alternative regulation plan is fatally flawed because its basic rates contain no provision for sharing productivity gains with ratepayers apart from the two-year rate freeze at the outset of the plan. According to Staff, the theoretical and empirical evidence from other jurisdictions justifies a determination that an X Factor above zero – i.e., a requirement that some productivity sharing be

included – is an essential component of any alternative regulation plan. It is further Staff's position that even with such an X Factor, approval would only be appropriate in service territories where there is evidence of competition in the form of actual, observed entry into the relevant market.

Staff noted that a rate freeze on basic services, which equates to an X Factor equal to the rate of inflation absent exogenous changes, would be appropriate for the first phase of the plan. Staff further took the position that, after the five-year freeze, an X Factor of 2.5 percent should be applied. Staff pointed out that under such a plan, the Company would still retain 100 percent of all productivity gains related to non-basic services.

In Staff's view, there is evidence that KTC can earn a reasonable rate of return with a positive X Factor. According to Staff, the Company's history of earnings above the Commission's authorized rate of return is evidence that KTC would be able to pass along productivity-related gains to customers. In contrast, according to Staff, an X Factor of zero "would simply be a continuous wealth transfer from ratepayers to shareholders." Exh. Staff 15 at 20.

With respect to service quality, Staff contends that the appropriate treatment in an alternative regulation plan is an asymmetrical one. In other words, Staff's position is that

the Company should be penalized for failing to meet service quality standards but should not receive additional rewards for achieving service quality benchmarks. According to Staff, this is appropriate because there are few if any substitutes available in the relevant market and, thus, customers cannot punish the company for poor service by selecting another supplier. In Staff's view, to be consistent with the public interest, an alternative regulation plan for KTC would have to contain a provision requiring termination of the plan in the face of sustained substandard performance in service quality. Staff points out that KTC presently maintains a high level of customer service. According to Staff, a sound alternative regulation plan would eliminate incentives to compromise service quality by making such a strategy unprofitable.

Staff contends that KTC has failed to establish the existence of any significant competition in its service territory and, thus, the record contains an insufficient factual basis to sustain the central premise for the Company's proposal. According to Staff, the only relevant evidence was the testimony of KTC's witness to the effect that two customers reported switching to wireless service in 2002 and another nine indicated that they would do so in the first quarter of 2003. Staff further noted that the Company's witness could not state the extent of wireless coverage in the KTC service territory, even

though a KTC affiliate is one of the area's wireless providers. According to Staff, the existence of actual competition is a condition precedent for alternative regulation, citing *New England Telephone and Telegraph Co.,* 76 NH PUC 393 (1991).

Other components of the KTC alternative regulation plan that Staff views as flawed include: (1) the inclusion in the definition of exogenous events (i.e., occurrences that lead to price increases outside the plan's formula) includes factors that are already accounted for because they are reflected in general price inflation within the economy as a whole, (2) the ability of the Company to terminate the plan, which Staff contends shifts downside risks to customers, (3) the lack of a cap on the price of non-basic services, (4) the maintenance of the Company's rural exemption under the Telecommunications Act, and (5) the questionable link between the infrastructure investment incentive and resulting consumer benefits.

Staff contends that traditional rate-of-return regulation has been a success in the KTC service territory and should be maintained. According to Staff, New Hampshire has more high-speed telephone lines on a total market basis than every state in the nation except Massachusetts, Rhode Island and California. In Staff's view, KTC has been making appropriate levels of infrastructure investment under traditional regulation and also has an excellent customer service record. KTC's

alternative regulation plan, according to Staff, would allow reduction in infrastructure investment and quality of service and therefore is not in the public interest.

## III. COMMISSION ANALYSIS

### A. Rate Issues

As we have previously noted, this case is analogous to a traditional, cost-of-service ratemaking proceeding, inasmuch as we must "make a determination as to the appropriate starting point" for any alternative regulation plan. Order No. 23,925, slip op. at 6; *see also* Order No. 24,056, slip op. at 6. We are thus required to decide whether the base rates requested by KTC are "not unduly discriminatory, are just and reasonable, and provide the Company with the opportunity to earn a reasonable return on its investment." Order No. 23,925, slip op. at 6; *see also Appeal of Conservation Law Foundation*, 127 N.H. 606, 633-34 (1986) (describing traditional ratemaking process). The purpose of the inquiry is to determine rates that fall in a "zone of reasonableness between the extremes of confiscating a utility's property, at one end, and exploiting customers for the utility's benefit, at the other." *Appeal of Public Service Co. of N.H.*, 130 N.H. 748, 750-51 (1988).

As noted by KTC, the issues in dispute along the road to just and reasonable rates are very few. We address each in turn.

1. **Bad debts**

The first issue concerns bad debts arising out of the Global Crossing and WorldCom bankruptcy filings, given that KTC is a creditor of both. According to KTC, these bad debts comprise a new type of business risk that generate known and measurable changes to KTC's test-year revenue. KTC proposes that we add $34,015 to the Company's revenue requirement, reflecting one third of the debts in question. In the alternative, KTC proposes a temporary surcharge on the Company's intrastate access rates to allow recovery of the debts or, similarly, a reduction in any refund arising out of KTC's over-earnings.

We are unable to agree with the premise that the bad debts are known and measurable expenses that should generate adjustments to test-year revenue. The record does not reflect that expenses of this type are recurring, despite KTC's assertion that this type of bad debt represents a new and persistent business risk for independent telephone companies. Thus, as the Commission stated in *Concord Steam Co.*, 71 NH PUC 667, 683 (1986), "unless such expenses are excluded, ratepayers will be required to pay such expenses on an annual basis in spite of the fact that they are no longer being incurred by the Company." As pointed out by the OCA, the record reflects that efforts to collect these debts by KTC were ongoing, and KTC was

claiming certain accounts payable as an offset against these bad debts. The letter received on January 23, 2004, from Attorney Lightbody, indicates that in December 2003, the Company recovered approximately 48 percent of the bad debt owed by WorldCom, through settlement. As to the claim against Global Crossing, the letter reports that a settlement was reached but payment of the settlement was conditioned on Global Crossing's emergence from bankruptcy and Global Crossing's continued financial ability to make payment following its emergence from bankruptcy. In the case of Global Crossing, the ultimate amount of bad debt is not known and measurable. Further, there is no evidence on the record that the expense will be a recurring one so as to be appropriate for inclusion in the Company's revenue requirement. Finally, KTC's ongoing efforts to collect the debts are themselves reflective of the reality that the ratemaking process is not designed to insulate utilities from the need to engage in such activities when appropriate.

Accordingly, we will not include an adjustment for bad debt of this nature in the revenue requirement. However, because we have determined infra that KTC should refund its temporary rates overcollection to IXC customers, we will allow KTC to reduce the amount of the refund of temporary rates by $61,995, the net amount of known and measureable bad debt reported in the letter received on January 23, 2004. We find

this treatment equitable because it assigns a cost associated with the IXC market to an IXC rate rather than to retail rates.

**2. Capital Structure**

We next turn to the question of what rate of return to apply to KTC. "[T]he rate of return is a percentage applied to the rate base expressed as a dollar amount in order to produce interest on long-term debt, dividends on preferred stock, and earnings on common stock (including surplus or retained earnings)." *Conservation Law Foundation*, 127 N.H. at 635 (citation and internal quotation marks omitted). Contrary to the suggestion of KTC, "[t]he actual needs of the company do not control what the commission may do when it sets the rate of return." *Id.* at 635-36. The Commission may set the rate of return "by reference to a capital structure that [the Commission] finds appropriate, rather than the actual capital structure of the company." *Id.* at 636. This is because "the object of the process is to strike a fair balance between recognizing the interests of the customer and those of the investor . . . rather than necessarily to guarantee . . . stockholders their dividends." *Id.*

The New Hampshire Supreme Court has stressed the role that judgment plays in setting a rate of return. *Id.* at 636. The Court has also stated that in striking a fair balance between the interests of the ratepayer and the shareholder as

required by *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591 (1944) and *Bluefield Water Works v. West Virginia Public Service Commission* 262 U.S. 679, 675 (1923), the Commission may impute a capital structure that it finds to be appropriate, rather than using the Company's actual capital structure. *Id.* In subsequent cases we have explicitly relied upon this principle, recognizing that "commissions are entitled to 'make the pragmatic adjustments which may be called for by particular circumstances,'" *Kearsarge Telephone Company*, 73 NH PUC 320, 326 (1988) (citing *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S 575, 586 (1942)), and must "exercise … a 'fair and enlightened judgment, having regard to all relevant facts,'" *id.* (citations omitted). In this instance, determining the allowable rate of return based on the utility's actual capital structure (84.63 percent common equity and 15.37 percent debt) would not strike a fair balance between the ratepayer and shareholder. Rather, it would tend to favor KTC's investors too heavily, given that KTC's total cost of long term debt is historically 6.24 percent and, based on any methodology we might reasonably apply here, KTC's cost of equity will be in excess of that figure.

Staff witness Schlegel testified that telecommunications carriers with Moody's ratings at investment grade (Baa) or higher have, on average, capital structures

consisting of debt and equity in equal parts. Staff therefore reasons that imputing such a capital structure to KTC is reasonable because it (1) reduces KTC's overall cost of capital to a more balanced figure, and (2) increases the leverage of the Company, and therefore its risk, but only to a level that does not threaten the utility's financial soundness.

This testimony is essentially unrebutted. A KTC witness, Mr. Woltman, testified that it is the policy of KTC's parent company to require KTC to maintain a credit rating of A-, which, according to Mr. Woltman, requires a capital structure that is at least 75 percent equity.

Because KTC is not separately traded we must use a hypothetical capital structure. As we did in our recent order establishing a new cost of capital for Verizon, we will look to what a reasonable and prudent manager would choose for a capital structure. *See Verizon New Hampshire*, Order No. 24,265 (Jan. 4, 2004), slip op. at 50.

KTC correctly points out that the actual capital structure employed by this or any other utility is a matter of discretion that is properly left to management. This argument, and similar statements in Mr. Woltman's testimony, imply that by imputing a capital structure to KTC we would, in effect, be substituting our judgment for management's. This is incorrect

KTC remains free to operate with whatever capital structure its owners and managers deem prudent.[1] The determination we make here, entirely consistent with established precedent, is that ratepayers cannot be expected to subsidize a strategy that unduly favors stockholders. As we stated in the *Verizon* order, excess equity creates a capital structure that is too rich, and accumulating excess equity means the utility is failing to take advantage of opportunities to raise lower-cost debt funding. Id. at 50-51. We believe that a prudent manager facing the need to raise capital in today's market would place greater emphasis on debt than KTC acknowledges. Accordingly, we adopt Staff's view that the financial soundness of KTC would likely be preserved under a capital structure where debt and equity are equal and we will therefore impute such a capital structure to the Company for ratemaking purposes in this case.

**3. Cost of Debt**

KTC asserted that if the Commission were to impute a capital structure, that it would be unreasonable for the Commission to apply the utility's historic cost of debt, 6.24 percent, to the rate calculation when the evidence suggests that KTC's current cost of borrowing is at least 7.5 percent.

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[1] For this reason, we are unpersuaded by KTC's suggestions that we (1) apply any imputed capital structure prospectively after a reasonable transition period, or (2) do not apply any imputed capital structure in the process of reconciling permanent to temporary rates.

However, as Staff pointed out at the hearing, the average long term cost of debt for maturities of 10 years and above observed for the five proxy telecommunications companies used by both Staff and the Company was 5.5 percent, significantly below the rate the Company claims is necessary to attract long term debt. Tr. 2/21/03 at 84. We therefore find that the 6.24 percent cost of debt, as reported by KTC on its books, meets the Company's financing needs and is reasonable in light of current debt market conditions.

**4. Cost of equity**

KTC requests that its cost of equity be fixed for ratemaking purposes at 15.07 percent. The utility makes a variety of arguments in support of that figure, which we address in the order presented in KTC's brief.

First, KTC contends that it is entitled to 31 basis points to reflect issuance costs and offers the testimony of KTC witness Makholm in support of this position. Mr. Makholm stated that in "many different regulatory jurisdictions" the practice of adding an increment to the allowed cost of equity to reflect issuance expenses is the "traditional way". Tr. 2/21/03 at 104.

We are unpersuaded. KTC cites no case, and we are aware of no contested case, in which this Commission has ever increased its calculation of a utility's cost of equity to reflect issuance expenses. We recently reiterated our

longstanding view that in the absence of any evidence of actual or planned issuances, such costs should not be compensated. *Verizon*, Order No. 24,265, slip op. at 69, citing *Pennichuck Water Works,* 70 NH PUC 850, 863 (1985). In our view, these transaction costs are already reflected in the relevant stock price.

The next issue raised by KTC concerns a so-called ex-dividend adjustment of six basis points. According to KTC, this corrects for a slight inaccuracy generated by employing the Discounted Cash Flow (DCF) model to arrive at a cost of equity.[2] As discussed, *infra*, although there is disagreement on the precise DCF methodology to be used in this case, all parties and Staff agree that DCF itself is appropriate here. Mr. Makholm testified, and KTC argues, that the DCF model fails to take into account the real-world increases in a company's stock price as the ex-dividend date (i.e., the date on which a stock must be owned if the owner is to receive an upcoming quarterly dividend

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[2] The DCF model assumes

> that the price at which an investor purchases stock is based on [the investor's] expectations as to the future yield in terms of dividends and sales price of the stock. By discounting the (expected) future yields at a rate which equalizes the present value of the future yields and the market price of the stock, the method arrives at a rate of return that the hypothetical investor is demanding on the given common stock issue. Calculation of this rate can also be obtained by adding the current dividend yield to the expected rate growth in dividends.

*Boston Gas Co. v. Department of Pub. Utils.*, 269 N.E.2d 248, 255 (Mass. 1971).

payment) approaches. KTC explains that because the DCF model always uses a formula that places the relevant stock price in the denominator, the ex-dividend effect would tend to reduce the allowed Return on Equity unless corrected. Mr. Makholm recommends an adjustment of 6 basis points.

We find that the cost of equity must be viewed from the investor’s perspective, that is, the rate of return on equity an investor requires in order to accept an equity stake in the company. By the company’s reasoning, the share price increases just before dividends are paid, and decreases thereafter as the next dividend payment is one quarter into the future. However, the investor accepts a higher share price – and therefore a slightly lower return – knowing that the cash dividend will be paid out shortly. This is evidenced by the fact that investors do not sell the shares of the proxy companies in droves as the dividend date approaches. No additional return on equity is therefore required as investors are willing to hold the shares at the going price. If it were, investors would be quick to have the share price reflect this fact. We are thus not persuaded that the company’s adjustment is necessary.

The next assertion of KTC is that we should reject the precise DCF formula employed by Staff witness Schlegel because it is inconsistent with methods used by Staff analysts in

previous cases. Specifically, KTC challenges Mr. Schlegel’s use of “least squares” methodology, his reduction in weighting of earnings (as opposed to dividends) to 25 percent as compared to previous cases in which earnings were weighted at 37.5 percent, his weighting of historic data at 66.7 percent and ValueLine data at 33.3 percent where Staff had previously used only ValueLine data, and Mr. Schlegel’s use of a three-stage version of the DCF model where the Commission has previously employed a one-stage version of the model.

We are aware of no legal principle, and KTC cites none, that requires a specific application of the DCF in our analytical approach to fixing a utility’s allowed cost of equity. The test is whether the methodology employed causes the cost of equity to fall within a “zone of reasonableness.” *Public Service Co. of N.H.*, 127 N.H. at 634-35 (stressing, generally, the Commission’s “discretion in setting each of [the] variables” in the traditional ratemaking formula); *see also Appeal of Manchester Gas Co.*, 129 N.H. 800, 806(1987) (holding that the Commission is free to depart from previous policy so long as the departure has a “reasonable basis”).

We begin with KTC’s last concern – use of the three-stage DCF analysis. The issue is what rate of expected growth in earnings and dividends to apply in calculating the present

value of the future cash flows associated with KTC's stock.[3] According to Mr. Schlegel, a one-stage DCF model assumes that the company's growth rate "can apply indefinitely." Staff Exh. 1 at 15-16. According to Mr. Schlegel, in such circumstances "the cost of equity would be too high, as the firm is being compensated for rewarding investors with growth so large that it eventually produces a telecommunications carrier equal to the size of the economy." *Id.* at 16.

The alternative proposed by Mr. Schlegel involves applying the ValueLine projection of the utility's growth rate for an initial period of five years, as opposed to indefinitely. This is Stage 1. At Stage 3, Mr. Schlegel would apply "the annual long run sustainable growth rate of the economy's nominal output," which he sets at 5.5 percent (comprised of real output growth of 3.5 percent and inflation of 2 percent). *Id.* at 16-17. Stage 2 simply "allows for a smooth convergence of the short run growth rate toward the long run." *Id.* at 17. According to Mr. Schlegel, use of the three-stage model yields a cost of equity that is 29 basis points higher than that derived from a one-stage model.

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[3] In considering the discussion that follows, it is useful to keep in mind that KTC stock is not traded on any market because it is a wholly owned subsidiary of a parent company. Thus, Mr. Schlegel estimated KTC's cost of equity by using figures from five publicly traded "proxy" companies that he believes are reasonably similar to KTC. See Staff Exh. 1 at 14. KTC's witnesses explicitly agreed with the proxy firms used by Mr. Schlegel.

In response, KTC witness Makholm concedes that "there is nothing inherently wrong" with a multi-stage DCF model. KTC Exh. 7 at 8. However, he contends that "the multi-stage DCF model is not likely to be useful in rate proceedings because reliable and appropriate data to implement the model is not available." *Id.* Specifically, Mr. Makholm questions both the Stage 1 and Stage 3 growth rates applied by Mr. Schlegel.

According to Mr. Makholm, Mr. Schlegel's estimate of the long-term growth rate (applicable at Stage 3) is appropriate for use in other contexts, but is inappropriate here because the DCF model measures investor expectations and "there is no evidence from financial markets to support Mr. Schlegel's assumption that investors believe that individual companies' growth rates begin to revert to an economy-wide mean after five years." *Id.* at 9-10. Mr. Makholm also argues that a single economy-wide growth rate would never be applicable to high-yield companies (such as gas utilities) and their low-yield counterparts in the telecommunications industry.

With regard to the short-term growth rate applied by Mr. Schlegel at Stage 1, which Mr. Makholm describes as a weighted average of historical and forecast dividend and earnings growth rates, Mr. Makholm's contention is that (1) the assumed dividend growth rates "are affected by past and projected trends in payout ratios, making them specifically

inapplicable proxies for prospective growth," and (2) the assumed earnings growth rates "show the traditional problems associated with the use of such figures for DCF analyses." *Id.* at 10. Noting that dividend payout ratios have been consistently declining in the telecommunications industry, Mr. Makholm proposes the use of only projected earnings growth rates. Apparently overlooking his own critique of the use of assumed earnings growth rates, he suggests that these projections be used exclusively, and applied in a single-stage DCF model to yield a "minimum estimate" of KTC's cost of equity (including the adjustments for issuance costs and the ex-dividend problem) of 13.20 percent, as opposed to Mr. Schlegel's estimate of 8.892 percent (which does not include those adjustments).

In rebuttal, Mr. Schlegel stresses the "underlying economic logic" of his DCF calculations, disputing that it reflects only the analyses of professional economists as opposed to the expectations of investors. *See* Tr. 2/21/03 at 208. He testified that the formula he applied did not come from any academic work but, rather, from a guide created for investment analysts. *Id.* He noted that, as a check of his calculations, he derived a cost of equity for KTC by using another methodology (the capital asset pricing model (CAPM)), yielding a rate that is below 9 percent. *Id., see also* Staff Exh. 1 at 17-19 (describing Mr. Schlegel's use of Ibbotson's Full Information

Beta method as a check of his DCF analysis, yielding a cost of equity of 8.56 percent). With regard to the suggestion of disregarding dividend growth projections, Mr. Schlegel stated that in such an instance one would "no longer [be] talking about a discounted cash flow, because the cash flows that we're discounting are the cash flows that the investor receives, not the cash flow that the Company has." Tr. 2/21/03 at 211 (conceding that "investors are also concerned with earnings," which is why he "assigns some weight to earnings, but not 100 percent").

In considering the contrasting views of these two economists, we begin by noting a significant development that post-dates KTC's suggestion that we have never departed from the one-stage version of the DCF model. We did just that, and endorsed the three-stage version, in our recent *Verizon* decision. *See Verizon*, Order No. 24,265, slip op. at 65 (noting that the three-stage version of the DCF comprises "refinement" and "improvement" over the one-stage version). The arguments and expert opinions presented here do not persuade us to deviate from the analysis we applied in the recent *Verizon* cost-of-capital proceeding. Essentially, we do not agree with Mr. Makholm that Mr. Schlegel's model, which takes reality into account over the long term, is inapposite because investors do not allow the long-term limits of the economy to color their

investment decisions. We agree with Mr. Schlegel that it would be inappropriate to abandon any use of dividend projections, for the reasons stated by him at hearing. And, like Mr. Schlegel, we draw comfort from the knowledge that checks using other methodologies produce results that are close to those derived by him using the three-stage DCF formula.

In sum, we adopt Mr. Schlegel's methodology, and find 8.89 percent a reasonable estimate of KTC's cost of equity.

**5. Rate case expenses**

In his pre-filed testimony, KTC witness Woltman estimates that the utility will have incurred $158,000 in recoverable rate-case expenses. He recommended that these costs be amortized over three years and that KTC's intrastate revenue requirement be adjusted accordingly. OCA counters that it is likely a good portion of these expenses are not recoverable because they are associated with KTC's petition for approval of an alternative form of regulation. According to OCA, a detailed audit is required.

To the extent that KTC is suggesting that we should resolve any rate-case expense issues now, and to the extent that the OCA is recommending that we adopt our usual practice of deferring this issue to after the case is decided on its merits and after Staff has had an opportunity to conduct a careful review of the claimed expenses, we agree with the OCA.

Accordingly, we will not take rate case expenses into account in establishing KTC's revenue requirement.

**6. Rate Design**

Both KTC and Staff take the position that if our decision on an authorized rate of return results in a determination that KTC has been over-earning (which it does), then any reduction in rates should be applied to intrastate access rates as opposed to the rates for basic service. OCA disagrees, contending that there is no correlation between access rates in New England (which are, obviously, paid by long-distance providers as opposed to retail customers directly) and the intra-state long distance rates that customers actually pay. According to the OCA, the better route would be to see that customers benefit directly as a result of this rate case, by reducing basic rates.

Staff witness Hart testified that KTC's access revenue may decrease in the future as toll substitutes provided by wireless services and the Internet become more prevalent. She posits, therefore, that there will be future pressure on basic rates, assuming that KTC's revenue requirement is a constant and access revenue decreases. Thus, Ms. Hart recommends that over-earnings be applied to access rates in order to reduce this pressure.

At hearing, Staff drew our attention to RSA 378:17-a, III(a), which directs us,

> as soon as possible after each significant decrease of interstate access charges by the federal government, [to] consider corresponding reductions in intrastate access charges, taking into account both the disadvantages to customers of intrastate access charges that exceed interstate access charges and the disadvantages to customers of increases in charges for basic services.

In that regard, Staff noted that KTC's interstate access rate is approximately 3.2 cents and its corresponding intrastate rate stands at roughly 11 cents. In Staff's view, the instant case represents an opportunity to protect basic rates while bringing intrastate access rates more in line with interstate access rates as required by the statute.

We agree with Staff. KTC's basic residential rates range from $9.39 to $14.41 per line per month which are relatively low when compared with rates charged by Verizon. Thus, we are not inclined to reduce them without a cost study. Access rates however, based on Staff testimony, appear to be the source of KTC's over-earnings. We will therefore use this opportunity to reduce access rates without the disadvantage of increasing local rates, consistent with RSA 378:17-a.

We recognize that KTC's customers may not immediately experience a reduction in intra-state long distance rates as a result of the reduction in access rates. However, we are

persuaded that customers will benefit in the long run from the maintenance of basic rates at current levels even if access revenue declines. It is also anticipated that as more local exchange carriers move the price of access toward cost, retail long distance rates will decline.

**7. Conclusion**

In light of the analysis above, it is our determination that the statutory requirement for just and reasonable rates requires us to recalculate KTC's cost of capital, based on an imputed capital structure of 50 percent equity and 50 percent debt, a cost of debt of 6.24 percent and a cost of equity of 8.89 percent. This yields a cost of capital of 7.6 percent. We decline to make the requested adjustment of KTC's revenue requirement to account for debts owed by Global Crossing and WorldCom.

In light of these determinations, we instruct KTC to confer with Staff and OCA and file with the Commission (1) revised schedules reflecting the determinations herein, (2) a calculation of the billing credit that will fully refund IXCs for the difference between the temporary rates authorized by Order No. 24,056 and the permanent rates we establish today, offset by $61,995, the known and measurable amount of bad debt, (3) a calculation of allowable rate case expenses, with a proposal for their recovery, and (4) a compliance tariff.

**B. Cash Management Fund**

Before turning to KTC's request for an alternative form of regulation, we pause briefly to resolve an unrelated matter that arose during the hearings on the alternative regulation issues. As noted, *supra*, the OCA sought during the alternative regulation hearings to introduce what it characterized as newly discovered evidence with respect to a "cash management fund" of approximately $10 million, maintained on the KTC books as retained earnings. Following discovery on that issue, we allowed the parties to present evidence with respect to this question. OCA contended that KTC should not be permitted to include these temporary investments in common equity for the purpose of calculating KTC's cost of capital, and asked the Commission to impose sanctions on the Company for failing to report the existence of this fund in its 1999, 2000 and 2001 annual reports.

We begin our discussion of this issue by noting that KTC is not unique with respect to the general practice of retaining earnings for loan to affiliates. We have previously approved such arrangements, both as to the lending and the borrowing of funds pooled among affiliates. *See, e.g., Northern Utilities*, Order No. 24,095 (Dec. 13, 2002); *EnergyNorth Natural Gas*, 85 NH PUC 755 (2000); *PSNH Proposed Restructuring Settlement*, 85 NH PUC 567, 592 (2000). The cash management fund

in which KTC has invested is similar to the Northeast Utilities money pool in which we allowed PSNH to invest as part of the restructuring of PSNH. Though not employed by every utility, inter-affiliate pooling arrangements are an accepted financing vehicle – and, indeed, the record reflects that we have explicitly approved the arrangement about which the OCA complains here.

In any event, it is unnecessary for us to address the issue on its merits. The OCA indicated that one appropriate resolution of this aspect of the case would be to adopt Staff's proposal with respect to an imputed capital structure. Since we have done so for other reasons, we treat OCA's other arguments with respect to the cash management fund as moot for purposes of calculating KTC's revenue requirements.

With respect to the OCA's related arguments, which ask us to impose a fine and to refine certain annual reporting requirements, we decline to take such steps for the following reasons. On the issue of fines, it is our finding that the record does not reflect evidence of wrongdoing on the part of KTC that would justify a financial penalty, assuming without deciding that these circumstances could constitute a failure to make and file a required report pursuant to RSA 374:17. Our denial of OCA's request for modification of certain reporting

requirements is without prejudice, since that subject is better addressed in a rulemaking or generic preceding.

**C. Alternative Form of Regulation**

Having determined the just and reasonable rates for KTC under the traditional rate-of-return methodology, the next question we confront is whether to allow those rates to remain in place on a permanent basis pursuant to RSA 378:28 or whether we should use the new rates as a baseline and grant KTC's request for an alternative form of regulation pursuant to RSA 374:3-a.

Pursuant to RSA 374:3-a, we may, after notice and hearing, approve an alternative form of regulation for KTC "other than the traditional methods which are based upon cost of service, rate base and rate of return." We may do so upon a determination that any such alternative "results in just and reasonable rates and provides the utility the opportunity to realize a reasonable return on its investment."

As noted by KTC, the Commission adopted rules to guide the RSA 374:3-a analysis. The relevant provision, Puc 206.07, requires us to approve an alternative form of regulation if we determine that such alternative

> [r]esults in rates that are not unduly discriminatory and are at a level that allows those to whom a service is being marketed to obtain such service;

> [p]rovides the utility the opportunity to realize a return on its investment which falls within a range that is neither confiscatory nor unduly profitable and that reflects the utility's investment risk; and
>
> [s]erves the public interest in light of the considerations described in Puc 206.06(b)(1) through (9).[4]

Puc 206.06(b), in turn, requires a utility seeking an alternative form of regulation to "describe in detail" the effects its proposal would have on these nine factors:

> (1) Competition;
>
> (2) The safety, adequacy and reliability of public utility service;
>
> (3) The traditional regulatory balance which does not unfairly benefit or disadvantage utility consumers, utility investors and other stakeholders;
>
> (4) Administrative efficiency in the regulatory process for the utility and the commission;
>
> (5) Economic development within New Hampshire;
>
> (6) Access to basic utility service to residents throughout the state, also known as universal service;
>
> (7) Innovation of services;
>
> (8) Infrastructure improvements; and
>
> (9) Environmental and conservation safeguards and incentives.

Our review of the record leads us to the determination that the extent to which the KTC proposal serves the public

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[4] These regulations and their authorizing statute, RSA 374:3-a, both post date *New England Telephone and Telegraph Co.*, 76 NH PUC 393 (1991). Thus, despite the extensive discussion of this case at hearing and in the briefs, we do not assess KTC's proposal against the standards used in that case to reject another ILEC's alternative regulation proposal.

interest in light of certain of the Puc 206.06(b) factors is the dispositive question. Accordingly, we begin by making factual findings as to the factors we regard as key.

Our first determination lies at the heart of the case. We find that competition for the provision of intrastate telephone service is almost entirely non-existent in the KTC service territory and the KTC proposal for alternative regulation is unlikely to lead to the creation of such competition. The record reflects that only a handful of customers have migrated from KTC while indicating they were opting for wireless service. The record further does not allow us to find that wireless service is physically available on a sufficiently widespread basis in the KTC service territory to make it a meaningful alternative for wireline customers.

Wireless, of course, is not the only possible form of competition in the KTC service territory. KTC offered certain additional evidence, to the effect that other alternative services *could* lead to customer migration, but no evidence that such migration has *actually* occurred.

We do not intend to suggest that it is imprudent or irrational as a business proposition for KTC to be mindful of the possibility of significant competition for

its current customers. From a strategic standpoint, such an awareness is useful to an ILEC as it plans for the future. We merely find that KTC has failed to demonstrate, and the record does not otherwise reflect, that competition presently exists to any significant extent that would allow KTC the freedom it seeks.

A more important factual issue is whether the KTC alternative regulation proposal is likely to generate such competition in the future. We answer that question in the negative. In arguing to the contrary, KTC points to its expressed willingness to waive its RSA 374:22-f state franchise protection.[5] In terms of opening the KTC service territory to competition among telephone companies, this is only a first step. As discussed at length during the hearings, KTC proposes that it maintain its so-called rural exemption under the Telecommunications Act after the utility’s conversion to alternative regulation.

Under the Telecommunications Act, ILECs have affirmative obligations to negotiate in good faith and ultimately interconnect with other telecommunications

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[5] RSA 374:22-f generally provides that no telephone utility shall extend its facilities so as to furnish telephone service in the franchise territory of another telephone utility that provides local exchange service and has fewer than 25,000 access lines. The only exception is when the incumbent telephone company requests such an extension and the Commission determines that the proposed new service would be consistent with the criteria set forth in RSA 374:22-e and 374:22-g.

carriers, providing unbundled and non-discriminatory access to the ILEC's facilities. 47 U.S.C. § 251(c). The rural exemption, 47 U.S.C. § 251(f), allows certain rural telephone companies, including KTC, to avoid these obligations. The exemption is not absolute. It may be overcome by a potential market entrant upon making a "bona fide request of a rural telephone company for interconnection," but only after the relevant state utility commission has thereafter determined that such request "is not unduly economically burdensome." 47 U.S.C. § 251(f)(1)(A). The statute provides for a period of up to 120 days for the making of such a state agency determination. *Id.* at (B).

Staff and OCA contend that the placement of such a regulatory barrier in the way of interconnection in the KTC service territory is the equivalent of maintaining KTC's exclusive franchise, given the practical significance of such a barrier to a potential entrant. KTC's response to this argument is somewhat conclusory. Its alternative regulation witness, Mr. Ulrich, testified that "[n]o state commission should waive its jurisdiction in this matter given that it only takes 120 days to ensure that a competitor's request to interconnect is technically feasible, not economically burdensome and is consistent

with federal universal service provisions and with the New Hampshire statutes." KTC Exh. 44 at 25. Reduced to its essence, KTC's position here is that it would be rational for the Commission to retain its right to review such developments and prevent them if necessary.

Accepting that proposition *arguendo*, it begs the question of whether the maintenance of the rural exemption promotes competition. We believe that an ILEC fully ready to embrace and encourage competition would waive the exemption. KTC has taken a half-step by agreeing to waive its state-law franchise exclusivity, but the perpetuation of the rural exemption under federal law would remain a significant disincentive (though not an insurmountable barrier) to competitive entry. On balance, therefore, the KTC proposal would be a step toward competition if implemented, but we cannot find that competition is likely to be promoted or enhanced if we were to approve the proposal.

The next question is the effect KTC's alternative regulation proposal would have on the safety, adequacy and reliability of the service it provides. Uncontested in this record is the fact that KTC presently provides service that is in all respects safe, adequate and reliable. KTC does not suggest that its proposal would have a positive

effect on these parameters; rather, it is the utility's position that its commitment to these objectives would remain unchanged under alternative regulation. There was considerable discussion at hearing of KTC's level of capital investment and whether the implementation of the KTC alternative regulation plan would tend to encourage or discourage such investment. According to Staff, KTC itself conceded at hearing that it would reap a service quality incentive payment under its alternative regulation plan simply by performing at the same levels, or in some cases, at lower levels than those reflected in KTC's 2002 statistics. We find that, from the standpoint of KTC, the best that can be said is that it would be neutral with respect to capital investment in particular and safety, adequacy and reliability in general.

We next take up the objective of maintaining "[t]he traditional regulatory balance which does not unfairly benefit or disadvantage utility consumers, utility investors and other stakeholders." There is no suggestion here that other stakeholders are involved and, indeed, none have appeared in this proceeding. In essence, then, this question is identical to the more general one contained in Puc 206.07, which limits us to an alternative regulation plan that "[p]rovides the utility the opportunity to realize a return on its investment which

falls within a range that is neither confiscatory nor unduly profitable and that reflects the utility's investment risk."

This brings us to the heart of Staff's objection to the alternative regulation proposal. In Staff's view, shared by the OCA, the regulatory balance is upset by an alternative regulation plan devoid of an X factor – i.e., a provision whereby a certain portion of productivity gains inure to the benefit of customers.

There is no disagreement that the alternative regulation plan proposed by KTC includes the equivalent of an X factor equal to the rate of inflation for two years. This is the effect of the freeze that would be applicable to basic and one-party business rates during that period. We agree with Staff and OCA that the inclusion of such a minimal productivity sharing mechanism unfairly benefits KTC's shareholders.

It is not our determination that we would never approve an alternative regulation plan with such a limited X factor. For example, a company that is already facing significant competition in its service territory (as distinguished from perceiving, rationally, that such competition is a significant possibility) might reasonably be allowed to keep all productivity gains because there would be a market-based check on the company's prices.

KTC, however, has a consistent record of over-earning (as reflected most recently in the rate issues decided *supra*) and faces the threat of competition but not its reality at present. In these circumstances, the minimal productivity sharing that is reflected in the KTC alternative regulation proposal would not fall within a range that is neither confiscatory nor unduly profitable. Rather, it would upset the traditional regulatory balance by unfairly benefiting utility investors.

The next issue is administrative efficiency in the regulatory process for the utility and the Commission. We give this criterion relatively little weight in this instance, inasmuch as potential benefits for consumers here could easily outweigh these considerations. However, it is our finding that the alternative regulation proposal does not contribute to administrative efficiency from either the standpoint of this agency or KTC. It is undisputed that the alternative regulation plan, if implemented, would add new reporting and monitoring requirements without terminating any such requirements that presently exist.

On the question of economic development, KTC contends that its alternative regulation plan will tend to meet this objective because (1) KTC would be waiving its exclusive franchise under state law, (2) the company will maintain a high-

quality infrastructure, and (3) KTC is committed to providing services to schools and libraries for educational purposes at rates that are lower than those charged to other customers. We find nothing in the record that supports a finding that the proposed alternative regulation plan furthers economic development in New Hampshire. As already noted, the franchise exclusivity waiver does not, in itself, open the KTC territory to competition. The other two factors cited by KTC are essentially descriptions of the company's present commitments and record, so it cannot be said that its alternative regulation plan will provide benefits in that sense.

The same determination applies to the "universal service" criterion. According to KTC, its commitment to making its basic utility service available throughout its service territory will remain unabated. Therefore, there can be no finding that opting for the alternative regulation plan will advance this objective.

Next we consider whether the KTC alternative regulation plan will lead to innovation in services. KTC points out that its alternative regulation plan would provide it with significant flexibility in this regard. The utility also notes that its state franchise exclusivity waiver will open its territory to new and presumably innovative companies, that the alternative regulation plan explicitly provides for tracking of

customer desires and that, generally, in order to meet competition KTC will need to maintain a network that allows for the rapid deployment of innovative services. We agree with KTC that the proposed alternative regulation plan would give it added pricing flexibility. However, we are not persuaded that competitors are likely to enter the service territory as a result of KTC's waiver of its exclusive franchise and thus, are not convinced that alternative regulation will lead to new, innovative services.

We have much the same view with respect to infrastructure improvements. KTC points out that it has historically maintained a very strong infrastructure, which it would continue to maintain and develop under its alternative regulation plan. If so, then it cannot be said that the alternative regulation plan is preferable to the current regulatory scheme with regard to such improvements.

Finally, there is the question of environmental and conservation objectives. According to KTC, its alternative regulation plan would not affect the utility's strong record in this regard. If so, this factor does not tend to advance the case for alternative regulation.

There is no suggestion here that the standards contained in the applicable regulations are not a reasonable interpretation of RSA 374:3-a. These

regulations require us to approve an alternative regulation plan if all three conditions in Puc 206.07 are met. It is our determination, based on the record adduced here, that two of those conditions have not been met. Specifically, the proposal would not result in rates that fall within a range that is neither confiscatory nor unduly profitable. And the proposal would not serve the public interest in light of the nine Puc 206.06 factors. As to most of those factors, the proposal neither advances nor harms the public interest, but the plan has insufficient measures to promote competition and allows nearly all productivity gains to benefit only shareholders. This would make the utility unduly profitable within the meaning of Puc 206.07 and upset the traditional regulatory balance described in Puc 206.06(b)(3). As a result, we are unable to find a benefit to approving the proposed plan for alternative regulation. Nevertheless, while we are compelled to reject this particular proposal, we seek to make clear that alternative regulation is a valuable policy option and is worthy of adoption in the appropriate circumstances.

**Based upon the forgoing, it is hereby**

**ORDERED**, that the petition of Kearsarge Telephone Company for an alternative form of regulation pursuant to RSA 374:3-a be, and hereby is, DENIED; and it is

**FURTHER ORDERED**, that Kearsarge Telephone Company file, by April 15, 2004, revised rate schedules reflecting the determinations herein, with a compliance tariff; and it is

**FURTHER ORDERED**, that by March 22, 2004, Kearsarge Telephone Company file its calculation of allowable rate case expenses, with a proposal for their recovery; and it is

**FURTHER ORDERED**, that by March 22, 2004, Kearsarge Telephone Company file for review, a calculation of the billing credit that will fully refund IXCs for the difference between the temporary rates authorized by Order No. 24,056 and the permanent rates we establish today, offset by $61,995, the known and measurable amount of bad debt.

By order of the Public Utilities Commission of New Hampshire this twentieth day of February, 2004.

| Thomas B. Getz<br>Chairman | Susan S. Geiger<br>Commissioner | Graham J. Morrison<br>Commissioner |
| --- | --- | --- |

Attested by:

Lori A. Legerstee
Assistant Secretary