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

C. Telecommunications' Company Customers

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

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

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

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

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

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

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

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

IV. Revenue Requirement Adjustments

A. Lost Revenue Adjustment

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

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

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

B. Team and Merit Awards

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

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

C. Management Salary Increase

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

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

D. Equity Return Adjustment

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

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

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

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

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

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

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

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

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

PART FOUR:

RESULTS OF OPERATION

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

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

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

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

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

I. Legal Standards

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

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

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

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

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

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

5. Any existing revenue excess or deficiency; and

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

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

II. Revenues

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

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

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

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

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

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

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

The Commission finds that Mr. Brosch is most credible in his analysis and that the revenue portrayal with his adjustment most accurately reflects the Company's ongoing operations. The Commission agrees with Mr. Brosch that the use of the test year has to be balanced. The Commission cannot take one event, the rate reduction, out of the context of what is happening in the entire operation. That is the purpose of a general rate proceeding. It is our primary duty to look at relationships among revenues, costs, and rate base as they relate to the future. Ms. Wright's presentation does not reflect the Company's shrinking rate base. To the extent that toll revenues are dropping, the Company did not submit an adjustment to reflect that, and the falling rate base will tend to ameliorate it. The Commission reasons that, therefore, Public Counsel's position should be adopted and both adjustments accepted.

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

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

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

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

As a condition to the merger of PNB into USWC, all of the parties including USWC agreed in a signed stipulation, presented to the Commission and approved, that if the merger were approved, Yellow Page revenues would be considered as though the merger had not taken place.[21] The order provided that the Commission could modify the arrangement by a future

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

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

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

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

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

order. The Alternative Form of Regulation (AFOR) agreement between the Commission and the Company in 1990 contained an implicit directory imputation calculation.

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

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

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

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

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

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

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

The Company's arguments are as follows:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[24] The Commission addresses all of the Company's arguments presented as to yellow page revenue imputation, even though many of the arguments are repetitious of matters previously argued and decided, and others are so patently silly that they insult the Commission's intelligence. USWC's argument that in effect alleges extortion, however, is shocking and outrageous. USWC presented not one iota of evidence supporting this claim. The Company's record of litigation before this Commission and in the courts demonstrates clearly that it knows how to secure redress speedily and successfully if it believes that its interests are adversely affected. If extortion occurred, unbeknownst to the Commission, we call on the Company to bring forward that

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

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

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

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

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

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

14. USWC contends that MRG does not have a monopoly and its return isn't inconsistent with competitive returns in the advertising business. It argues that there is no evidence that USWC's association with USWD leads people to advertise in the directory. The directory does not use public right of way or eminent domain power of the utility. Imputation conflicts with RCW 80.36.300, encouraging diversity of supply.

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evidence so investigation and possible prosecution can occur. Without that evidence this accusation has no place in a professional presentation.

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

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

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

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

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

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

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

* * * *

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

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

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

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

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

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

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

In making this decision, we also consider the unchallenged fact that the vast majority of USWC's 15 jurisdictions also impute directory revenues. We note USWC's concession on brief that the matter was decided in a prior order. We note (1) Mr. Brosch's testimony that US WEST Direct grossed approximately a billion dollars and earned a return of

205% in 1994, (2) his contention that for Washington operations it earned 229%, and (3) his contention that US WEST Direct's return on equity has exceeded 150% every year since 1989, when publisher fees ended. We find that the segregated US WEST Direct operation did in fact earn substantially more than the authorized utility rate of return on its investment.

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

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

C. Service Quality

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

III. Operating Expenses

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

A. Restructuring PFA-9

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

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

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

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

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

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

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

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

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

C. Jurisdictional Separations

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

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

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

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

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

D. External Relations SA-11

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

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

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

E. Promotional Advertising, SA-8

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

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

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

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

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

F. Interconnection with Independents, PFA-11; C-2

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

G. Compensation Issues

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

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

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

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

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

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

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

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

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

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

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

2. Compensated Absence Adjustment, RSA-12

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

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

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

a. Team Awards

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

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

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

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

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

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

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

As the Commission noted in the Washington Natural Gas order cited above, there is a potential tension between service quality and earnings. A firm can concentrate on financial elements so heavily that it can lose sight of the importance of providing customer service. In a public utility service, where many customers have no reasonably substitutable alternatives, the

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

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

[30] Id., page 19.

Commission must substitute for the competitive market in assuring that customer service remains a priority to the business. Financial goals are at best a very crude way to measure specific efficiencies that employees can accomplish.

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

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

b. "Merit" Awards

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

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

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