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

4. Benefit Expense, RSA-14

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

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

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

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

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

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

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

I. Amortization of Debt Call Premiums, PFA-8

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

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

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

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

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

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

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

We do note that Commission Staff has prepared a pro forma adjustment to implement the depreciation rates found appropriate in Docket No. UT-940641. The Company does not contend that Mr. Spinks' calculation is in error. The Commission will adopt Commission Staff's pro forma adjustment to depreciation expense and accumulated depreciation. The effect of the adjustment is an increase in NOI of $5,049,375 and an increase in rate base of $1,165,240.

## IV. Affiliated Transactions

### A. General Considerations.

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

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

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

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

[32] RCW 80.16.030.

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

and US WEST Advanced Technologies (USWAT), from which it purchases research and development; and with US WEST, Inc. (USWI), from which it purchases various management services.

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

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

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

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

The Commission finds no facts, no rationale, and no citations of authority, to indicate that the Company's accounting practice is appropriate for ratemaking purposes. Accounting for book purposes, even pursuant to rules that the Commission has established or adopted by reference, does not control accounting for ratemaking purposes. WAC 480-120-031(1)[34] All the revenues from MRG for those functions should be considered above the line revenues for ratemaking purposes. The revenues relate to a formerly proprietary function, a regulatory asset, that the Company transferred without compensation. Under the Company's proposed treatment, the ratepayers would not only be deprived of the revenues from earnings, but also deprived of the full benefit of payment for services it formerly performed for itself, thus losing twice. The Commission accepts Commission Staff's calculation of the adjustment, virtually identical to that of Public counsel/Tracer, increasing NOI by $1,052,896.

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

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

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

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

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

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

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

The Commission accepts the Commission Staff use of the competitive bids for purposes of pricing the affiliated interest transaction.[36] The Commission finds the testimony of Ms. Strain credible in support of this adjustment.

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

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

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

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

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

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

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

Public Counsel/TRACER witness, Mr. Brosch, discusses the costs associated with research and development by USWC affiliates U S WEST Advanced Technologies (USWAT) and Bell Communications Research, Inc. (Bellcore) on page 63 of his testimony. The projects he removed dealt with multimedia services, future video, and broadband and wireless network technologies. As does Commission Staff, he finds that many of the projects undertaken by these affiliates do not have current ratepayer benefits. Many of the projects either extend to

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

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

nonregulated activities or relate to services far beyond the potential of current telephone technology. His disallowance proposals suggest that if at some future time the Company can demonstrate that these projects do benefit ratepayers, they should be allowed to request recovery of the costs with interest. A side record would be kept to track potential future recovery. As documentation he provides Exhibits 394, 395 and 396 to show descriptions of the contested projects. On rebuttal, he states that his adjustments on Bellcore, USWAT, and the parent vary from staff's mainly on the basis of scope. He believes his position to be more conservative than that of Commission Staff.

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

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

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

The Commission accepts the Public Counsel/TRACER approach to both Bellcore and USWAT. We prefer it to Commission Staff's similar approach because it is more clearly documented and offers long-term opportunity for recovery. We find no legal bar to using a side record for potential recovery. We find that it is specific as to project, so that benefit will be

simple to determine. The approach will allow the Company to recover the costs of many projects immediately and will allow the full recovery of all deferred projects that prove beneficial to regulated operations -- in a manner that is not retroactive ratemaking, but that allows recovery on a prospective basis when benefit is determined. USWC does not demonstrate that the approach is improper, and side records may, as here, be entirely appropriate for ratemaking purposes.

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

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

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

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

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

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

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

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

Neither is the Commission persuaded that the costs of image advertising is appropriately borne by ratepayers. The Company contended as to a prior issue, and the Commission agreed, that the appropriate test remains whether advertising encourages the purchase of services that provide a contribution above expenses. Here, there is no evidence that the corporate image expenses meet that test. The Commission believes that the Commission Staff proposed adjustment more accurately removes inappropriate costs, and the Commission accepts the Commission Staff proposed adjustment, which increases NOI by $1,232,375.

## V. Taxes

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

C. Pension Asset RSA-16

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

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

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

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

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

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

D. System X Deferred Tax Difference, RSA-16

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

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

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

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

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

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

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

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

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

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

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

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

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

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

F. Tax Effect of AFUDC, RMA-3

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

Commission Staff proposes to offset the Company's adjustment with deferred taxes based upon its theory that depreciation of AFUDC must generate a reduction in deferred taxes. The Company responds that in order to have a tax effect of depreciation there must be revenue. It cites Ms. Wright's testimony that nonoperating revenues generated these deferred taxes, and it

reasons that because the deferred taxes were "below the line", depreciation of the AFUDC cannot generate above-the-line deferred taxes. The Commission finds that the Company's explanation is correct.

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

G. Interest Synchronization, C-16.

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

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

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

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

Commission Staff proposed to include CWIP in the calculation of pro forma interest. The Commission notes that there is no testimony supporting Staff's modification. The Commission is aware that in many previous orders CWIP was included in the calculation to the

extent companies were not required to capitalize interest for tax purposes. As there is no evidence to support this modification in this proceeding, it follows that the Commission will exclude CWIP from the calculation.

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

### H. Uncontested Adjustments

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

## VI. RATE BASE

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

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

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

#### 1. Pension Asset

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

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

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

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

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

2. Lead-Lag or Investor Supplied Working Capital Study

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

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

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

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

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

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

3. Declared Dividends

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

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

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

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

## VII. Conclusion and Table

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

US WEST COMMUNICATIONS
WASHINGTON INTRASTATE OPERATIONS
TWELVE MONTHS ENDING OCTOBER 1994

| LINE NO | | | | COMMISSION FINDINGS NOI | COMMISSION FINDINGS RATE BASE |
|---|---|---|---|---|---|
| 1 | NET OPERATING INCOME & RATE BASE - PER BOOKS | | | $89,076,000 | $1,473,014,000 |
| | ADJUSTMENTS: | | | | |
| 2 | RMA #1 | DEREGULATED MOBILE RADIO | | $276,544 | ($813,085) |
| 3 | RMA #2 | MERGER EXPENSE | | 8,797 | (239,208) |
| 4 | RMA #3 | AFUDC (MEMORANDUM IDC) | | (2,499,012) | 23,140,741 |
| 5 | RMA #4 | POLITICAL ACTION EXPENSE | | 9,819 | 0 |
| 6 | RMA #5 | DEPRECIATION REFUND AMORTIZATION | | (3,003,288) | 16,796,490 |
| 7 | RMA #6 | DEPRECIATION RESERVE | | 16,905,658 | 128,295,423 |
| 8 | RMA #7 | FLOW THROUGH OF NON-PROPERTY TAX | | 801,812 | 4,547,960 |
| 9 | RMA #8 | OPEB | | 97,331 | (7,036,298) |
| 10 | RMA #9 | SHARING ADJUSTMENTS | | 0 | (31,035,616) |
| 11 | RSA #1 | OCCUPATIONAL WAGE ANNUALIZATION | | (1,972,844) | 0 |
| 12 | RSA #2 | MANAGEMENT SALARY ANNUALIZATION | | (747,663) | 0 |
| 13 | RSA #3 | RATE REDUCTION | | (4,442,152) | 0 |
| 14 | RSA #4 | RENT COMPENSATION | | (63,000) | 0 |
| 15 | RSA #5 | AFFILIATED INTEREST BILLING ADJUSTMENT | | 1,232,375 | 0 |
| 16 | RSA #6 | PENSION CREDIT REDUCTION | | (740,377) | 0 |
| 17 | RSA #7 | FEDERAL INCOME TAX ADJUSTMENT | | 1,071,554 | 1,902,019 |
| 18 | RSA #8 | INSIDE WIRE AMORTIZATION | | 173,885 | 134,000 |
| 19 | RSA #9 | PRIMARY TOLL CARRIER | | (3,929,557) | 0 |
| 20 | RSA #10 | CLASSIFICATION ADJUSTMENT | | 711,913 | 0 |
| 21 | RSA #11 | PURCHASE REBATE ADJUSTMENT | | 282,169 | 0 |
| 22 | RSA #12 | COMPENSATED ABSENCE ADJUSTMENT | | 390,000 | 0 |
| 23 | RSA #13 | TEAM & MERIT AWARD ADJUSTMENT | | 6,384,966 | 0 |
| 24 | RSA #14 | BENEFIT EXPENSE ADJUSTMENT | | 711,076 | (64,341) |
| 25 | RSA #15 | PROPERTY TAX RESTATEMENT | | 84,787 | 0 |
| 26 | RSA #16 | FLOW THROUGH TAX RESTATEMENT | | 13,033,193 | 10,898,426 |
| | RSA #17 | OUT OF PERIOD ADJUSTMENTS | | | |
| 27 | | OOP #1 | PRE-DIVESTITURE TAX ISSUES | (73,855) | 0 |
| 28 | | OOP #2 | ASSET CLEARANCE | 222,024 | 0 |
| 29 | | OOP #3 | ACCOUNT RECONCILIATION | 821,489 | 0 |
| 30 | | OOP #4 | INCOME TAX | (496,570) | 0 |
| 31 | | OOP #5 | PROPERTY TAX | (1,951,422) | 0 |
| 32 | | OOP #6 | LEGAL SETTLEMENT | (197,320) | 0 |
| 33 | | OOP #7 | INDEPENDENT COMPANY | 894,215 | 0 |
| 34 | | OOP #8 | PURCHASE REBATE | (1,227,247) | 0 |
| 35 | PFA #1 | OCCUPATIONAL WAGE INCREASE | | (3,381,860) | 0 |
| 36 | PFA #2 | MANAGEMENT SALARY INCREASE | | (1,482,081) | 0 |
| 37 | PFA #3 | PENSION ASSET | | 0 | 69,915,604 |
| 38 | PFA #4 | CASH WORKING CAPITAL | | 0 | 0 |
| 39 | PFA #5 | MATERIAL AND SUPPLIES | | 0 | 0 |
| 40 | PFA #6 | CAPITAL RECOVERY | | 5,049,375 | 1,165,240 |
| 41 | PFA #7 | RURAL SALES | | 4,210,071 | (43,542,000) |
| 42 | PFA #8 | AMORT. OF DEBT CALL PREMIUM EXPENSE | | 539,257 | 0 |
| 43 | PFA #9 | RESTRUCTURING ADJUSTMENT | | 11,408,953 | (11,766,524) |
| 44 | PFA #10 | OPEB CURTAILMENT LOSS | | 0 | 0 |
| 45 | PFA #11 | INTERCONNECTION WITH INDEPENDENTS | | 0 | 0 |
| 46 | PFA #12 | POSTAGE | | (449,476) | 0 |
| 47 | SA #1 | YELLOW PAGES | | 50,934,378 | 0 |
| 48 | SA #2 | HELD ORDERS | | 0 | 0 |
| 49 | SA #3 | JURISDICTIONAL SEPARATIONS | | 6,805,250 | (35,722,831) |
| 50 | SA #4 | MARKET RESOURCE GROUP | | 1,052,896 | 0 |
| 51 | SA #5 | INVESTOR SUPPLIED WORKING CAPITAL | | 0 | (37,796,518) |
| 52 | SA #6 | RURAL SALES SETTLEMENT | | 0 | 0 |
| 53 | SA #7 | BRI | | 2,374,375 | 0 |
| 54 | SA #8 | ADVERTISING ADJUSTMENT | | 0 | 0 |
| 55 | SA #9 | REGULATORY FEE (COMPANY OOP #9) | | 178,682 | 0 |
| 56 | SA #10 | CHARITY CONTRIBUTIONS | | 0 | 0 |
| 57 | SA #11 | EXTERNAL RELATIONS | | 338,911 | 0 |
| 58 | SA #12 | OVERTIME AND CAPITALIZATION | | 0 | 0 |
| 59 | C-1 | RECURRING REVENUE | | 9,508,000 | 0 |
| 61 | C-16 | INTEREST SYNCHRONIZATION | | 4,925,548 | 0 |
| 62 | C-11 | OCCUPATIONAL ANNUALIZATION | | 0 | 0 |
| 63 | C-12 | MANAGEMENT ANNUALIZATION | | 0 | 0 |
| 64 | C-6 | BELLCORE DISALLOWANCE | | 606,000 | 0 |
| 65 | C-7 | USWAT PROJECT DISALLOWANCE | | 286,000 | 0 |
| 66 | C-8 | US WEST INC. CHARGES | | 0 | 0 |
| 67 | TOTAL ADJUSTMENTS | | | $115,673,579 | $88,779,482 |
| 68 | NET OPERATING INCOME ADJUSTED | | | $204,749,579 | $1,561,793,482 |

## VIII. Rate of Return

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

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

**COMPARISON OF RATE OF RETURN CALCULATIONS**

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

A. Cost of Debt

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

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

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

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

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

B. Cost of Preferred

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

C. Cost of Equity

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

The Commission rejects Mr. Cummings' proposal to use a group of non-telephone comparable companies. The Company's own case argues that Mr. Hill's use of gas distribution companies is not comparable. Those companies have lower bond ratings and higher debt ratios

than are experienced in the telephone industry, facts that should tend to produce equity returns which are higher -- but as argued by Mr. Cummings and admitted by Mr. Hill, the gas companies are generally considered to have lower equity return requirements. So, too, the AA-rated industrial companies have capital structures with approximately 73% equity, yet their bond ratings are no higher than the bond ratings of USWC. The conclusion one draws is that these companies carry greater business risk, and it is difficult at best to conclude that the measurement of these companies' equity capital is comparable to that of USWC.

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

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

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

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

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

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

D. Capital Structure

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

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

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

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

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