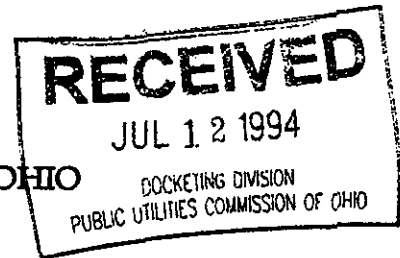


BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO



In the Matter of the Application of
the Ohio Bell Telephone Company for
approval of an alternative form of
regulation.

)
)
) Case No. 93-487-TP-ALT
)

In the Matter of the Complaint of the
Office of the Consumers' Counsel,

Complainant,

vs.

)
)
) Case No. 93-576-TP-CSS
)
)

The Ohio Bell Telephone Company,

Respondent.

Prepared Testimony
of
J. Edward Hess
Accounts and Audits Division

Staff Exhibit 16

1 1. Q. Please state your name and business address.

2
3 A. My name is J. Edward Hess. My business address is 180 E. Broad Street,
4 Columbus, Ohio 43266-0573.
5

6 2. Q. By whom are you employed?
7

8 A. I am employed by the Public Utilities Commission of Ohio.
9

10 3. Q. Would you please state your background?
11

12 A. I received a Bachelor of Business Administration degree from Ohio
13 University in 1975 with a major in accounting. I was employed by the
14 Public Utilities Commission of Ohio from August 1975 until May 1977 as
15 a junior accountant. I then worked for the certified public accounting
16 firm of John Gerlach and Company from September 1977 until July of
17 1978. Between July 1978 and July 1980 I was employed in various
18 accounting and construction positions. I began my current employment
19 with the Public Utilities Commission of Ohio in July of 1980.
20

21 4. Q. What is your current position with the Public Utilities Commission of
22 Ohio and what are your duties?
23

24 A. I am the Accounting Officer in the Accounts and Audits Division of the
25 Utilities Department. My duties are to supervise and direct the
26 accounting functions of the division, establish standards of work
27 performance for use by professional staff in utility rate case

1 investigations, advise professional staff on appropriate treatment of
2 unique issues encountered in investigations, review work products of
3 professional staff for conformance with quality standards and
4 recommend revisions as appropriate, investigate issues of general
5 significance and develop staff policy consistent with department
6 objectives, serve as senior advisor on technical matters to Staff engaged
7 in rate case investigation project planning, testify in administrative
8 hearings on general policy issues, develop training programs and
9 provide training and instruction.
10

11 5. Q. What are your responsibilities and what is the purpose of your
12 testimony in this proceeding?
13

14 A. I have the overall responsibility for the operating income and rate base
15 sections of the Staff Report. I am also sponsoring the Staff's position on
16 the exogenous adjustment of the price cap formula and defending the
17 Staff's recommendation to adjust current revenue requirements before
18 initiating price cap regulation.
19

20 Specifically, I will respond to the Applicant's Objections A3, A5, A6, B1,
21 B7 - B17, B19 - B21, C-1, D5a, D5b, and E1; Office of Consumers' Counsel
22 (OCC) Objections 10, 11, 56, 59-63, 65, 67-69, 73, and 74; the Ohio Cable
23 Television Association's (OCTVA) Objections 2, 18, and 19; Legal Aid
24 Society of Dayton's Objections 9 and 10; American Association of Retired
25 Persons' Objections 16 and 17; Greater Cleveland Welfare Rights
26 Objections 13 and 30; Time Warner's Objections I-3, III-6, III-7, and III-8;

1 and the Department of the Army's Objection to operating income and
2 rate base described on page 3 of its set of objections.

3
4 Materials and Supplies in Working Capital

5
6 6. Q. The Applicant has objected to the Staff's failure to include materials and
7 supplies in Property Used and Useful (Working Capital) by its Objection
8 A3. Will you respond to this objection?

9
10 A. Prior to submittal of its filing, the Applicant informed the Staff that it
11 would not request an allowance for working capital. This was to
12 alleviate the requirement to perform and submit a lead lag study. The
13 Staff accepted the Applicant's explanation and recommended that the
14 Commission not require the Applicant to prepare and file a lead lag
15 study. Therefore, without a lead lag study, the Staff would make no
16 recommendation for a working capital allowance.

17
18 7. Q. Why can't the Staff include the materials and supplies without a lead lag
19 study?

20
21 A. The working capital allowance is comprised of a revenue lag component,
22 an expense lag component and a component for materials and supplies.¹
23 It would be improper to include only a portion of this allowance without
24 measuring the other components of the allowance.

1 Gas and Electric companies also include an allowance for fuel and the percentage of income plan.

1 8. Q. The Applicant's witness Kukla states on page 35 of his Additional
2 Supplemental testimony that the Staff's treatment of materials and
3 supplies is inconsistent with its treatment of customers deposits and
4 unclaimed funds. Will you respond to this allegation?
5

6 A. The Staff treats customers' deposits and unclaimed funds as Other Rate
7 Base Items on its Schedule B-6. Both of these items are considered
8 customer supplied funds and are used as rate base deductions with or
9 without an allowance for working capital.
10

11 9. Q. Has the Staff ever included customers' deposits and unclaimed funds in
12 its working capital allowance?
13

14 A. Several years ago the Staff included these items on its Schedule 11.²
15 These items, however, were included for presentation purposes only,
16 and were never considered a part of the working capital allowance.
17

18 Statement of Financial Accounting Standards Board (SFAS) 106
19

20 10. Q. Will you explain SFAS 106, Employers' Accounting for Postretirement
21 Benefits Other than Pensions?
22

23 A. Postretirement Employee Benefits Other Than Pensions (OPEB) are
24 comprised of various benefits other than retirement income that are
25 provided by an employer to its retired employees. Examples of these

² Before the Staff revised its Schedules to the A through C format, the working capital allowance was calculated on Staff's Schedule 11.

1 benefits include health care, life insurance, tuition assistance, legal
2 services, financial advisory services and housing subsidies. Historically,
3 the amounts paid for these benefits have been relatively minor and,
4 therefore, the cash method of reporting was deemed acceptable for
5 accounting and ratemaking purposes. However, with rapidly escalating
6 health care costs and ever increasing mortality trends, the promise to
7 provide such benefits has led to quite a large liability.

8
9 The Financial Accounting Standards Board (FASB) addressed the issue of
10 this undisclosed liability in their Statement of Financial Accounting
11 Standards No. 106 - Employers' Accounting for Postretirement Benefits
12 Other Than Pensions (SFAS 106) issued in December 1990. Within SFAS
13 106, the FASB reasoned that OPEB is deferred compensation earned by
14 employees and incurred by employers as the employee renders service
15 necessary to be eligible for postretirement benefits. Further, the FASB
16 concluded that recognition and measurement based upon best estimates
17 of the obligation to provide OPEB is superior to implying, by a failure to
18 accrue such costs, that no such obligation exists. SFAS 106 is generally
19 effective for fiscal years beginning after December 15, 1992.

20
21 SFAS 106 requires that employers accrue an expense equal to the net
22 periodic postretirement benefit cost. The accrual associates the
23 employers' promise to provide future OPEB during the period the
24 employee earns this future benefit.

25
26 The net periodic postretirement benefit cost recognized by an employer
7 includes following components:

- Service Cost: the portion of the total obligation for postretirement benefits attributed to employee service for the current period;
- Interest Cost: the increase in the present value of the accumulated benefit obligation due to the passage of time;
- Return on Plan Assets: (for funded plans) the expected earnings of the assets; if the fund holding the plan assets is a taxable entity, the return on plan assets reflects the tax expense or benefit for the period;
- Amortization of Prior Service Cost: the amortization of the cost of retroactive benefits due to plan amendments or initiation of a plan subsequent to the adoption of SFAS 106;
- Gains and Losses: changes in the total expected benefit obligation due to changes in assumptions or from experience different from that assumed; for funded plans this component also includes the difference between the actual and expected returns on plan assets; and
- Amortization of Transition Benefit Obligation: if delayed recognition of the transition benefit obligation (TBO) is elected, the straight-line amortization of the unrecognized transition obligation existing at the time of initial adoption of SFAS 106.

1 Upon adoption of SFAS 106, employers have a previously unrecognized
2 and unfunded liability for benefits under the current plan that
3 employees have earned as of that date. SFAS 106 gives employers the
4 option to either immediately recognize that liability or to recognize it on
5 a delayed basis through amortization over the average remaining service
6 period of active plan participants, or 20 years if the average remaining
7 service period is less than 20 years.

8
9 11. Q. Did the Public Utilities Commission of Ohio initiate any specific action
10 for utilities implementing SFAS 106?

11
12 A. Yes. In October 1992, the Commission opened an investigation into the
13 impact of SFAS 106 on Ohio utilities (Case No. 92-1751-AU-COI). In its
14 February 25, 1993, Finding and Order, the Commission indicated its
15 intention to allow utility companies to use OPEB expense calculated on
16 the SFAS 106 accrual basis for ratemaking and regulatory accounting
17 purposes. The Commission stated that the method of recognizing the
18 TBO and the amortization period for the obligation would be
19 determined on a company specific basis.

20
21 12. Q. When did the Applicant adopt SFAS 106?

22
23 A. The Applicant implemented SFAS 106 for financial reporting purposes
24 effective January 1992. The Applicant chose the immediate recognition
25 option for the TBO. In 1992, the Applicant wrote-off its entire TBO of
26 approximately \$481,193,000, plus approximately \$38,000,000 which
27 represents its share of ASI's TBO. Ameritech's Form 8K and Ohio Bell's

1 Form 10K submitted to the SEC also stated "As defined by SFAS No. 71, a
2 regulatory asset associated with the recognition of the transition
3 obligation was not recorded because of uncertainties as to the timing and
4 extent of recovery in the rate-making process."
5

6 13. Q. In its February 25, 1993, Finding and Order in Case No. 92-1751-AU-COI,
7 the Commission offered companies an opportunity to apply for deferral
8 of the difference between the OPEB accrual cost and the benefits paid plus
9 any other OPEB cost currently reflected in rates (incremental costs) until
10 the accrual costs were reflected in rates but no longer than five years. Did
11 Ohio Bell request permission to defer its incremental costs?
12

13 A. No, it did not seek permission to defer the incremental costs. Thus,
14 according to the February 25, 1993, Finding and Order, the Commission
15 should consider the Applicant's rates to include recovery of OPEB
16 expense calculated on the accrual basis as of the required
17 implementation date, January 1, 1993.
18

19 The Applicant also began accumulating the regulatory liability in
20 accordance with the Commission's Finding and Order.
21

22 14. Q. How did the Applicant treat OPEB costs in this case?
23

24 A. The Applicant included approximately \$70,440,000 of SFAS 106 costs in
25 its test year expenses. This cost was reduced by \$2,496,000, in an attempt
26 to reflect 1993 levels. Of the \$70,440,000, \$22,715,000 represents an
27 eighteen-year amortization of the Applicant's TBO while \$16,800,000

1 represents a one-time curtailment loss due to the Applicant's recent
2 reduction in employees. The curtailment loss is directly associated with
3 the amortization of the TBO. In addition to the \$70,440,000 of OBT
4 expenses, the Applicant has included \$2,020,000 for ASI's TBO
5 amortization.

6
7 The Applicant has also reflected the liability accumulated in compliance
8 with the Finding and Order in Case No. 92-1751-AU-COI as a rate base
9 deduction. The date certain balance was \$65,408,000. The Applicant has
10 also increased the rate base by the date certain balance of deferred taxes
11 related to the tax/book timing difference associated with SFAS 106. This
12 balance was \$21,305,000.

13
14 15. Q. How did the Staff treat this cost in the instant case?

15
16 A. The Staff rejected the Applicant's attempt to annualize its 1993 cost
17 levels, eliminated the amortization of the TBO (both OBT and ASI), and
18 eliminated the curtailment loss, on its Schedule 3.7.

19
20 The Staff adjusted the date certain tax/book deferred balance to reflect
21 both its adjustments to the test year expense and to reflect a first time
22 normalization of this item.

23
24 16. Q. Why did the Staff exclude the TBO amortization from the revenue
25 requirement in this case?

1 A. The Staff has recognized SFAS 106 accrual costs for ratemaking purposes
2 consistent with the Applicant's treatment of this cost for financial
3 reporting purposes. Hence, the Staff did not include the amortization of
4 the TBO as part of its OPEB accrual cost.

5
6 The Staff's recommendation is consistent with sound regulatory policy.
7 The intent of a base rate case is to establish rates that will allow the
8 Applicant an opportunity to recover a reasonable return on its
9 investment and to recover a normally expected level of operating
10 expenses. This cost does not exist now nor will it exist in the future and,
11 thus, it should not be included in future rates.

12
13 The purpose of accounting is to report economic conditions and events
14 as they occur and in a manner which will be relevant both to a
15 company's shareholders and to the general public. SFAS 71 recognizes
16 that regulatory decisions result in economic effects. SFAS 71 also
17 recognizes that public utility accounting should follow the ratemaking
18 treatment of transactions when such accounting results in a more
19 appropriate matching of revenues and expenses and proper recognition
20 of assets and liabilities of the utility. SFAS 71 states that the economic
21 effect of regulatory decisions is the pervasive factor that determines the
22 application of generally accepted accounting principles.

23
24 Regulatory treatment must be correctly portrayed on published financial
25 statements prepared under generally accepted accounting principles. A
26 commission's actions are based on many considerations. Accounting
27 should address the impacts of those actions. The financial accounting for

1 these economic effects should be consistent with the ratemaking
2 treatment set by the Commission. External financial statements which
3 do not recognize the economic effects of the regulator's decisions are
4 misleading as they do not accurately report the economic effects of that
5 regulation.

6
7 The Applicant is requesting the Commission to reflect an expense for
8 ratemaking purposes which has already been fully recognized for
9 financial reporting purposes. The Applicant's proposed ratemaking
10 treatment of the TBO creates a mismatch between the ratemaking
11 treatment of this item and its treatment in externally published financial
12 statements, which is contrary to generally accepted accounting principles.

13
14 Rates, and thus revenues, are designed to recover a company's cost of
15 providing service. Under GAAP the recognition of an expense for
16 financial reporting purposes should be synchronized with the booking of
17 revenues which are intended to include recovery of that expense.
18 However, if the Commission includes the amortization of the TBO in
19 rates, this synchronization will not occur. Further, the Applicant's
20 future net income as reported in published financial statements will be
21 overstated by several million dollars. Revenues will be higher due to
22 the inclusion of this expense in the revenue requirements but the
23 financial statements will not reflect the corresponding expense which
24 gave rise to the higher revenue.

25
26 17. Q. Mr. Kukla in his testimony references the Commission's statement in
27 the Finding and Order in Case No. 92-1751-AU-COI that the Commission

1 intended to treat the TBO similar to reserve deficiency amortizations. Is
2 the Staff's treatment of the TBO for OBT consistent with the treatment of
3 reserve deficiency amortizations?
4

5 A. Yes, it is. The Applicant voluntarily chose the immediate recognition
6 option for the TBO instead of amortizing the TBO over 18 years. Thus,
7 the Applicant's immediate recognition of the TBO is nothing more than
8 an accelerated amortization of the TBO. If the TBO is considered similar
9 to reserve deficiency amortizations, then the Staff believes OBT's
10 voluntary acceleration of the TBO amortization should be treated the
11 same as an accelerated amortization of a reserve deficiency.
12

13 The Commission has addressed numerous requests by companies who
14 wish to have the option to accelerate an amortization of a depreciation
15 reserve deficiency at their discretion. In these cases, the Commission has
16 indicated that any accelerated amortization is for book purposes only.
17 The Commission has gone on to state that any additional expense
18 created by such accelerated amortization will not be used as a basis for an
19 increase in current or future rates. Thus, the Staff believes it has treated
20 the TBO similar to reserve deficiency amortizations.
21

22 18. Q. Do you have any recommendation if the Commission does reflect the
23 amortization of the TBO in rates?
24

25 A. Yes. If the Commission does adopt the Applicant's proposed treatment,
26 the Staff would recommend that the Commission also order OBT to
27 create a regulatory asset for its published financial statements equivalent

1 to the TBO which it will be recovering through rates. If a regulatory asset
2 is not recognized and the economic effects of the Commission's
3 ratemaking decisions are not recognized in the financial statements, the
4 external financial statements will be misleading.

5
6 Generally accepted accounting principles require that a regulatory asset
7 be created on the books of the company if it believes recovery of an
8 expense is probable in a time period other than the period in which it
9 was incurred. Nothing in the Commission's Finding and Order would
10 lead Staff to conclude that the Commission would not recognize an
11 amortization of the TBO as a recoverable expense. Even the FCC
12 indicated it would allow recovery of the TBO on an amortized basis.
13 Staff is not aware of any uncertainty surrounding the recoverability of
14 the TBO which would have led the Applicant to conclude that no
15 regulatory asset should be recorded. In fact, since both the FCC and this
16 Commission indicated their intent to allow recovery, to the extent the
17 Applicant has not recorded a regulatory asset to record the difference
18 between financial and possible ratemaking, the Applicant may not be in
19 compliance with GAAP.

20
21 19. Q. Mr. Kukla in his testimony implies that OBT was treated differently than
22 Cincinnati Bell Telephone (CBT) and Western Reserve Telephone
23 Company in their recent alternative regulation cases. Do you agree?

24
25 A. No I do not. The Staff has recognized the SFAS 106 costs for ratemaking
26 purposes for OBT, Western Reserve and CBT consistent with that
27 particular company's treatment of the accrual for financial reporting

1 purposes. While it is true the Staff in Western Reserve and CBT did
2 recommend the TBO amortization be recognized for ratemaking
3 purposes, this treatment was also consistent with each company's
4 treatment of the TBO for financial reporting purposes. Both CBT and
5 Western Reserve elected the delayed recognition option for the TBO.
6 Thus, the Staff's recommended treatment in all 3 cases results in the
7 appropriate synchronization of revenues and expenses for financial
8 reporting purposes.
9

10 Statement of Financial Accounting Standards Board (SFAS) 112
11

12 20. Q. Will you explain SFAS 112, Employers' Accounting for Postemployment
13 Benefits.
14

15 A. Postemployment benefits encompass several types of benefits provided
16 to former or inactive employees, their beneficiaries, and covered
17 dependents. These benefits include, but are not limited to, salary
18 continuation, supplemental unemployment benefits, severance benefits,
19 disability-related benefits (including workers' compensation), job
20 training and counseling, and continuation of benefits such as health care
21 benefits and life insurance coverage. Historically, accounting varies for
22 employers who provide benefits to former or inactive employees, but
23 before retirement. Some employers accrue the estimated cost of those
24 benefits over the related service periods of active employees. Other
25 employers apply a terminal accrual approach and recognize the
26 estimated cost of those benefits at the date of the event giving rise to the
27 payment of the benefits (i.e., the death of an active employee, the

1 temporary or permanent disability of an active employee, or the layoff of
2 an employee). Still other employers recognize the cost of
3 postemployment benefits when they are paid (cash basis). Some
4 employers may use different methods of accounting for different types of
5 benefits.

6
7 The FASB established accounting standards for employers who provide
8 postemployment benefits to former or inactive employees, but before
9 retirement, in their Statement of Financial Accounting Standards No.
10 112, Employers' Accounting for Postemployment Benefits (SFAS 112) in
11 November 1992. This statement required employers to recognize the
12 obligation to provide postemployment benefits in accordance with FASB
13 Statement No. 43, Accounting for Compensated Absences.

14
15 SFAS 112 became effective for fiscal years beginning after December 15,
16 1993.

17
18 21. Q. Did the Public Utilities Commission of Ohio initiate any specific action
19 for utilities implementing SFAS 112?

20
21 A. No.

22
23 22. Q. What did the Applicant do in response to SFAS 112?

24
25 A. The Ohio Bell Telephone Company implemented SFAS 112 in January
26 1992. The Applicant wrote off \$25,461,000 to operating income.

1 23. Q. How did the Applicant treat this cost in this case?

2
3 A. In the current alternative rate case, the Applicant included the
4 \$25,461,000 in its operating expenses. The Applicant also increased its
5 rate base by \$8,462,000 for the deferred taxes and reduced its rate base by a
6 GAAP liability associated with SFAS 112 of (\$24,889,000).
7

8 24. Q. How did the Staff treat this cost?

9
10 A. The Staff did not include the transition benefits (TB) amortization
11 related to SFAS 112, nor did the Staff include the associated deferred
12 taxes and regulatory liability in its rate base calculation.
13

14 25. Q. By its Objection A6, the Applicant objected to the Staff's failure to reduce
15 its rate base by the liability created by the adoption of SFAS 112. Will you
16 respond to this objection?
17

18 A. The Staff did not use this liability to reduce its rate base because it is not
19 considered a rate payer supplied source of capital (or funds). It is simply
20 a liability created by generally accepted accounting principles, or a GAAP
21 liability. The principle cost of this liability has not been included in prior
22 rates of this Applicant so it could not have been collected by the
23 Applicant as a ratepayer supplied source of capital.
24

25 This GAAP liability is not to be confused with the regulatory liability
26 created by SFAS 106. The SFAS 106 regulatory liability was a direct result
27 of Commission directives in Case No. 92-1715-AU-COI.

1 26. Q. The Applicant has objected to the Staff's exclusion of the SFAS 112
2 transition obligation costs from operating expenses by its Objection B12.
3 Will you respond to this objection?
4

5 A. This cost should not be included for many of the same reasons that the
6 TBO portion of SFAS 106 is not included.
7

8 This cost was written off and will not reoccur in the future. The
9 Applicant did not request that the cost be deferred for recovery in a
10 future rate case. Including this cost in the revenue requirement
11 calculation would cause a mismatch of future revenues and expenses
12 that would be inconsistent with SFAS 71 requirements.
13

14 Applicant's Kukla Adjustments
15

16 27. Q. The Applicant has objected to the Staff's rejection of its adjustment to
17 local revenues by its Objection B1 and to its adjustment to materials and
18 supplies by its Objection B15. Will you respond to these objections.
19

20 A. In the last paragraph on page 11 of the Staff Report, the Staff describes the
21 two types of budget adjustments that the Applicant proposed to its base
22 year. These are the MR/FR adjustments and the View adjustments. The
23 View adjustments were further broken down into two types of
24 adjustments. One type updated the 1993 Annual Commitment View to
25 the more current 1993 Monthly Commitment View.³ The other type of

3 See the description of Annual Commitment View vs. Monthly commitment View on page 11 of the Staff Report on Investigation.

1 View adjustment reflected its witness' belief of what the 1993 period
2 should look like. These adjustments were not supported by the 1993
3 Monthly Commitment View but were instead based on a simple
4 historical analysis and the witness' belief that these adjustments were
5 necessary.

6
7 The Staff's adjustment to local revenues on its Schedule C-3.1 and Staff's
8 adjustment to materials and supplies on its Schedule C-3.8 are two
9 examples of View adjustments that were not supported by the 1993
10 Monthly Commitment View.

11
12 After reviewing the 1993 Monthly Commitment View and the process
13 that created it, the Staff accepted the View adjustments that updated the
14 1993 Annual Commitment View to the 1993 Monthly Commitment
15 View, but rejected the View adjustments that simply reflected the
16 witness' unsubstantiated vision of the 1993 period.

17
18 28. Q. Is there any reason why the Applicant's witness would have better
19 information to project operating income for 1993 than the company
20 personnel who are responsible for predicting this outcome?

21
22 A. I do not know the answer to that question. That is why we rejected his
23 adjustments. We viewed them as simply one person's estimate versus
24 the rest of the company's estimate and we believed that the rest of the
25 company's personnel were in a better position to project the operating
26 income.

Employee Head Count

29. Q. The Applicant, by its Objections B7, B14, B16, and B19, objects to the Staff's use of a year-end employee head count to annualize test year wage and benefit expenses. What is the Staff's position on this item?

A. Under normal circumstances, the Staff recommends that the labor annualization be based on an average of test year employees. However, the Applicant's test period employment situation was not normal. The Applicant was in the middle of implementing employee reductions which would permanently decrease its future operating expenses. This reduction had to be recognized in the revenue requirement calculation, and the Staff's use of year-end employees in its calculation recognized this reduction.

30. Q. The Applicant stated that it is not objecting to the Staff's removal of the wage and benefits expenses for the 88 employees who left the business by September 30, 1993 under its separation plan. The Applicant, however, is objecting to the Staff's methodology. Please respond.

A. Taking an average of test year employee levels and reducing it by the number of employees officially separated would not reflect the most current costs of employees who left the business. The Applicant's employee base declined during the test year and is continuing to decline. Given the test year concept, the end of test year employee count is the best estimate of the number of employees that will be employed when the rates from this case are in effect.

1 31. Q. The Applicant argues that this is a selective use of year-end levels, and if
2 such levels are to be used, then property tax and depreciation expenses
3 should reflect these levels. It further argues that plant in service should
4 also be updated to year-end levels. Will you respond to these
5 arguments?

6
7 A. The use of a plant in service valuation date was established by the
8 legislature. I am informed by counsel that the Commission does not
9 have the flexibility to change that valuation date. I, therefore, cannot
10 recommend a valuation of rate base that this Commission could not
11 accept. Regarding the depreciation and property tax expenses, these
12 calculations should be synchronized with plant in service. This is
13 consistent with past Commission decisions.⁴

14
15 32. Q. In addition to the employee head count, the Applicant objects to the
16 Staff's calculation of the O&M factor utilized to calculate the Applicant's
17 base year FICA expense. Will you respond to this objection?

18
19 A. Applicant's witness Kukla states that the test period expense calculated
20 by the Staff on its Schedule C-3.16, Line 13, is overstated? Mr. Kukla also
21 states that some of the total employee benefits used in the ratio of
22 footnote (d) are charged directly to expense and are not subject to the
23 O&M factor. The Applicant has estimated these expenses at \$24,876,000.⁵

24

⁴ Opinion and Order, Case No. 85-675-EL-AIR at page 58 and 59.

⁵ Total expense of \$162,029,000 (Staff Schedule C-3.16, footnote (d)) minus \$137,153,000 (Applicant's Additional Supplemental Testimony Workpapers, WP ST-IS #11 page 1 of 1, footnote (D)).

1 I agree in principle with the Applicant that directly assigned expenses
2 should not be included in calculating this factor. However, I could not
3 identify these expenses and I was unable to verify that they were directly
4 assigned to expense.

5
6 Supplemental Income Protection Plan and Severance Pay
7

8 33. Q. By its Objection B8, the Applicant objected to the Staff's use of a three-
9 year amortization of Supplemental Income Protection Plan (SIPP) and
10 Severance Pay expenses found on the Staff's Wage Expense Adjustment
11 on Schedule C-3.5. Will you respond to this objection?
12

13 A. The Applicant estimated its test period SIPP cost to be \$16,413,000. The
14 Applicant explained that the majority of this cost was due to the high
15 number of employees exiting the business during the test period.
16

17 The Staff amortized the Applicant's test period SIPP expenses over three
18 years because the amount far exceeded the expected annual cost. The
19 Applicant estimated that its ratio of SIPP to non-management wages
20 should be at 0.21%.⁶ That would have resulted in an expected test period
21 cost of approximately \$603,000.⁷ The Staff's adjustment is intended to
22 include a normally expected level of operating expenses for the test
23 period.
24

6 Applicant's WP 93C-3.2b page 1 of 2.

7 .21% times \$287,242,000 from Staff Schedule C-3.5, line (8).

1 The Applicant also estimated that it would incur a cost of approximately
2 \$2,256,000 as an incentive for employees accepting the early retirement
3 offering, or severance pay during the test period. Again, the Staff
4 adjusted this expense to reflect a normal level of operating expenses
5 during the test year.

6
7 Incentive Compensation Program

8
9 34. Q. The OCC has objected to the Staff's inclusion of incentive compensation
10 wages by its Objection 60. Will you respond to this objection?

11
12 A. OCC witness Hixon recommends eliminating incentive compensation
13 paid to employees when the incentive compensation is based on the
14 income objectives of the Applicant. Ms. Hixon states that the
15 Applicant's ability to achieve its net income goals will benefit its
16 shareholders, not its rate payers.

17
18 I disagree with Ms. Hixon's statement that income benefits only the
19 shareholder. A profitable utility company is also beneficial to the
20 ratepayer. A profitable utility company does not require increases in
21 rates while it is able to provide safe and reliable utility service.

22
23 Increasing profits is the result of expanding revenues or controlling, or
24 decreasing costs. There are many external influences that affect utility
25 companies, (i.e. inflation, technological changes, accounting changes, tax
26 changes). Increasing revenue and controlling costs helps to offset these

external changes. These offsets help delay or permanently postpone increases to the rates that utilities are required to charge their customers.

Offering compensation to utility employees as an incentive to expand revenues and control costs is a prudent utility cost that should be allowed in this case.

Pension

35. Q. By its Objection B13, the Applicant objects to the Staff's "selective disallowance" of the Applicant's adjustment to pension expense. The OCC objects to the Staff's determination of adjusted operating expenses because it did not base pension expense on the most recent actuarial study for the Applicant's pension programs, by its Objection 62. Will you respond to these objections?

A. The adjustment that the Staff selectively disallowed was an adjustment proposed by the Applicant to revise the test year expense from -\$24,639,000 to an estimated 1993 level of -\$15,996,000. The Staff rejected the adjustment because the 1993 level was not based on the most recent actuarial study. Rather it was based on an estimate that was calculated to accrue as a monthly expense during 1993.

I agree that pension expense should be based on the most recent actuarial study for the test period. The number that was used in the Staff Report was the most recent information available at the time of the issuance of the Report. The Applicant now states that the most recent actuarial

1 study supports the 1993 expense of -\$21,702,000.⁸ I agree in principle but I
2 have not reviewed the study to verify its accuracy.

3
4 Equal Access

5
6 36. Q. By its Objection B17, the Applicant objects to the Staff's calculation of
7 jurisdictional equal access expense for the base year. Do you agree with
8 this objection?

9
10 A. I agree. Equal access expense caused the intrastate jurisdictional
11 allocation factor for Account 6728 to vary from those of the other
12 General and Administrative Expenses.⁹ Since the Staff eliminated the
13 equal access expense from the Total Regulated Adjusted column
14 (Column 1) on Staff's Schedule C-2, page 5 of 6, there was no need to
15 weight the jurisdictional factor.

16
17 The intrastate jurisdictional allocation factor for Account 6728, on Staff's
18 Schedule C-2 should be corrected to be the same used for the other
19 General and Administrative expense accounts.

20
21 Property Tax Expense

22
23 37. Q. By its Objection B20, the Applicant objects to the Staff's use of actual tax
24 rates, and argues instead that its estimated rates should be used. Do you
25 agree with this objection?

⁸ Applicant's Additional Supplemental Testimony Workpapers, WP ST-IS #10, line 1.

⁹ Applicant's WP 93C-1.3, page 3 of 8.

1 A. No. Only known and measurable increases within the test year should
2 be used to calculate annualization adjustments. This has been an
3 accepted Commission policy for many years. The only exception to this
4 is the use of known and measurable increases outside of the test year for
5 tax changes.
6

7 38. Q. Would the exception that you site above be applicable for property tax
8 rates?
9

10 A. Yes. If the Applicant can quantify a more recent known and measurable
11 increase, I would recommend that it be used in the property tax expense
12 calculation.
13

14 Affiliates
15

16 39. Q. OCTVA, by its Objection 2 object to affiliate costs. Will you respond to
17 these objections?
18

19 A. Neither the OCTVA or the City of Mentor provided any testimony to
20 support their objections. These objections are too general to respond to.
21

22 Community Issues and Priority Survey
23

24 40. Q. The OCC has objected to inclusion of costs for a survey titled
25 Community Issues and Priority Survey by its Objection 74. Will you
26 respond to this objection?
27

1 A. While the Ameritech/Ohio Bell 1993 Community Issues and Priorities
2 Survey-Summary of Results was not the result of unbiased scientifically
3 defensible sampling, the thrust of the research, that of collecting public
4 input from various user groups on telecommunications interests, needs
5 and priorities, closely parallels the Staff's intent on recommending a
6 public input and customer education process that reaches out to a variety
7 of customer groups in OBT's service territory. Since the alternative
8 regulation rules require public input for the development of
9 commitments and require the Commission to evaluate the public input
10 in light of commitments in the public interest, the Staff believes that the
11 costs for the Ameritech 1993 Community Issues and Priorities Survey
12 should be included.

13
14 Federal Income Tax Expense

15
16 41. Q. By its Objection B21, the Applicant objects to several components of the
17 Staff's federal income tax calculation. What is your response?

18
19 A. The Staff addresses each of the Applicant's concerns below.

20
21 42. Q. The Applicant objects to the Staff's application of the weighted cost of
22 debt to the Property Used and Useful results. The Applicant argues that
23 the Staff's calculation imputes non-existent interest and totally ignores
24 the interest expense the Applicant will incur in the base year. What is
25 your response?
26

1 A. The Staff's method for inputting interest on rate base has been adopted
2 by the Commission in numerous rate proceedings, including the
3 Applicant's prior case. The Staff's method of determining interest
4 expense deduction accomplishes consistency between operating income,
5 capital structure, and rate base. It also reflects the proper and accurate
6 implementation of inter-period interest allocation recommended in this
7 proceeding.

8
9 Because interest costs provide a tax benefit, test year operating expenses,
10 to be consistent with the capital structure, should reflect the tax benefits
11 associated with the interest costs used in determining the cost of debt in
12 the calculation of the overall rate of return. If ratepayers are required to
13 provide a rate of return which reflects interest costs associated with the
14 debt portion of capital structure, it is only logical that they also receive
15 the tax benefits associated with such interest costs.

16
17 For the purpose of this proceeding, the Staff's calculation of the
18 deduction for interest charges for federal income tax purposes is based on
19 the percentage of weighted cost of debt included in the overall rate of
20 return multiplied times the Applicant's jurisdictional rate base. The
21 application of this percentage to the rate base determines the amount of
22 interest component included in the total recommended return on
23 investment. The interest amount determined in this fashion is the
24 proper amount that should be used in federal income tax calculations in
25 order to obtain the desired matching and consistency of operating
26 income, not only with capital structure, but also with the rate base.

1 It should be apparent that the use of the Staff's method correctly relates
2 the tax benefit derived from the interest deduction with the revenue
3 collected from ratepayers for the interest expense.
4

5 It should be understood, however, that any change in the rate base or the
6 weighted cost of debt and the overall rate of return, either as a result of
7 the Staff revision or by Commission decision, will change the calculation
8 of interest charges.
9

10 43. Q. The Applicant objects to the Staff's failure to normalize nonregulated
11 tax-to-book timing differences. Do you agree with this objection?
12

13 A. Yes. The Staff concurs with the calculation provided by the Applicant's
14 Witness Kukla, which supports his Additional Supplemental
15 Testimony.¹⁰
16

17 44. Q. The Applicant objects to the erroneous calculation of deferred taxes
18 related to the excess of tax accelerated over tax straight-line depreciation
19 on Schedule C-4. What is your response?
20

21 A. The Staff agrees with the Applicant that the jurisdictional amount
22 should be the product of the intrastate portion of total regulated tax over
23 tax straight-line depreciation at the 35% rate.
24

25 45. Q. The Applicant objects to the Staff's failure to properly adjust its
26 calculation of tax straight-line depreciation for the effects of depreciation

¹⁰ Applicant's Additional Supplemental Testimony Workpapers.

1 on short term interest during construction (STIDC) balances. What is
2 your response?
3

4 A. The Staff agrees with the Applicant that tax straight-line depreciation
5 should exclude the effects of STIDC balances. The Staff's revision to tax
6 straight-line depreciation is attached as Exhibit JEH-1 to my testimony.
7

8 46. Q. The Applicant objects to the Staff's failure to adjust the amortization of
9 prior years deferred income taxes to reflect the change from a 34%
10 federal income tax rate to a 35% rate, and to reflect its adjusted
11 jurisdictional depreciation expense. What is your response?
12

13 A. The Staff agrees with the Applicant that the amortization of prior years
14 deferred income taxes should reflect a 35% federal income tax rate and be
15 based on the adjusted jurisdictional depreciation expense. The Staff,
16 however, does not understand why the Applicant's calculation includes
17 the full amount of its depreciation related adjustments of \$444,000
18 (Additional Supplemental Testimony Workpapers, WP ST-IS #20). The
19 Staff's revised calculation is attached as Exhibit JEH-2 to my testimony.
20

21 47. Q. The Applicant objects to the Staff's failure to properly adjust its
22 calculation of amortization of investment tax credits to fully reflect the
23 impact of represcribed depreciation rates. Do you agree?
24

25 A. In so far as the calculation reflects PUCO represcribed depreciation rates,
26 the Staff agrees with the additional \$992,000 proposed in the Additional
27 Supplemental Testimony of Theodore W. Kukla.

1 Financial Analysis of the Applicant's Plan

2
3 48. Q. The Applicant has objected to the removal of the SFAS 106 TBO
4 amortization from and the inclusion of API directory revenues with the
5 income and equity balance by its Objections D5a and D5b. Will you
6 respond to these objections?

7
8 A. The Staff disagrees with these objections. The Applicant wrote-off the
9 SFAS 106 TBO in 1992. Earnings from 1994 through 1998 will not
10 include this expense. It would be misleading and completely wrong to
11 include this expense in the projected financial statements of this utility.

12
13 The Staff supports the inclusion of API revenues with the jurisdictional
14 revenue requirements and, therefore, recommends that these revenues
15 be included with any analysis of future jurisdictional earnings
16 calculations.

17
18 Base Year vs. 1994

19
20 49. Q. On Page 3 of its objections, The Department of the Army has objected to
21 the Staff's use of the base year as the basis to adjust the Applicant's
22 current revenues. Will you respond to this objection?

23
24 A. The Staff discussed this issue on Page 4 of the Staff Report. The 1994
25 information provided by the Applicant was based on a preliminary 1993
26 budget, selectively adjusted for inflation and known changes. The
27 Applicant later filed Exhibit H which contained 1994 information that

1 contradicted (or updated) the 1994 information provided in the original
2 application. Exhibit H information was based on a preliminary 1994
3 budget. The final approved 1994 budget was not available for the Staff's
4 review during its investigation, or as recent as late February 1994.

5
6 Based on its review of both the base year and the 1994 information, the
7 Staff believes that the base period information is a more reliable source
8 to establish rates in this case.

9
10 Other Issues

11
12 50. Q. The OCC and the GCWRO have raised several issues on Belcore
13 expenses, artwork investment, medical and dental expense, logo
14 changes, advertising, USA dues, and external relations. Specifically,
15 these are addressed by OCC Objections 56, 59, 61, 63, 65, 67, 68, 72, and 73;
16 and GCWRO objection 30. Will you respond to these objections?

17
18 A. The Accounts and Audits Division is given the overall responsibility of
19 determining that the financial information in a company's application is
20 reliable, verifiable and can be supported by the Applicant. Accounts and
21 Audits is also responsible for determining that the Applicant has kept its
22 accounting records in compliance with acceptable utility accounting
23 standards and that its accounting system is used as a source of
24 information contained in its application. This investigation includes
25 verification of both actual and budgeted information.
26

1 Accounts and Audits also has the direct responsibility for determining
2 that operating income and rate base are calculated in compliance with
3 Ohio base rate making rules.
4

5 To meet these responsibilities, the Accounts and Audits staff defines the
6 system that is the source of the financial information. That system is
7 tested to verify that it actually exists. The test of that system is completed
8 by sampling certain parts of the system and tracing the sample back to its
9 origin. Accounts and Audits does not review all the detailed financial
10 information included in an application. It would be physically
11 impossible to review everything, given the time constraints of a base rate
12 case investigation.
13

14 The OCC and GCWRO have raised several issues on matters that
15 Accounts and Audits did not review in this case. As a result, we can
16 neither verify the accuracy of dollar values attached to these issues nor
17 do we have a recommendation as to whether these issues should or
18 should not be considered in the Commission's final determination of a
19 revenue requirement.
20
21

22 PRICE CAP REGULATION

23 24 Starting Point 25

26 51. Q. By its Objection C1, the Applicant has objected to the Staff's use of
27 traditional rate base/rate of return analysis as the "starting point" for the

1 Staff's entry into alternative regulation. Will you respond to this
2 objection?

3
4 A. The Staff believes that if price cap regulation is to be adopted, the current
5 rates of the Applicant must be updated. This is consistent with National
6 Regulatory Research Institute Study Team (N-ST) recommendation 7.1
7 on Page 128 of the Addendum to the Staff Report and is supported by the
8 Staff's findings that the revenue requirements of the Applicant are
9 currently overstated.

10
11 52. Q. Time Warner objected to the Staff's failure to find that Ohio Bell's
12 current rates are excessive by its Objection I-3.

13
14 A. I disagree with the objection. The Staff has recommended that the
15 overall revenue requirements of the Applicant be reduced. This
16 recommendation is summarized on Staff's Schedule A-1, on Page 130, of
17 the Staff Report. Several Staff witnesses, including myself, are being
18 presented to defend that recommendation.

19
20 The Staff's cost of service witness will discuss how this revenue decrease
21 will affect the rates of the Applicant.

22
23 Exogenous

24
25 53. Q. Several of the parties and the Applicant object to the Staff's position on
26 exogenous adjustments as a part of the price cap formula. Specifically,
27 these are addressed in Applicant's objections E1 and E16; OCC objections

1 10 and 11; OCTVA objections 18 and 19; Legal Aid Society of Dayton's
2 objections 9 and 10; American Association of Retired Persons 16 and 17;
3 GCWRO's objection 13; and Time Warner's objections III-6, III-7, and
4 III-8.

5
6 The Applicant's proposal regarding an exogenous factor is included in
7 the direct testimony of its witness Romo. The National Regulatory
8 Research Institute (NRRI) Study Team (N-ST) discuss the Applicant's
9 exogenous adjustment in Chapter 5 of the Addendum to the Staff Report
10 of Investigation (Addendum). The N-ST also discuss and define
11 exogenous adjustments in general. The Staff's recommendation begins
12 on page 41 of the Staff Report of Investigation.

13
14 Is the Staff recommending that an exogenous factor be included in the
15 price cap formula?

16
17 A. Yes. The Staff believes that the Commission should have a mechanism
18 to reflect the impact of exogenous events in a price cap framework. The
19 Staff also believes that only the Commission should have the ability to
20 initiate and implement any exogenous impact adjustments within the
21 price cap formula.

22
23 54. Q. What is the Staff's definition of exogenous cost changes?

24
25 A. The Staff accepts the N-ST definition on page 87 of the Addendum. The
26 N-ST defines exogenous changes as " those thought to be outside the
27 control of a manager and are extraordinary costs, the magnitude of

1 which overwhelm the range of pricing flexibility and production
2 efficiencies reasonably expected to be available to a utility manager".
3

4 55. Q. Does the Staff believe that the Commission should define its criteria for
5 exogenous cost factors adjustments?
6

7 A. Yes. The Staff believes that it is important for the Commission to
8 establish criteria that it would follow in selecting future exogenous
9 events for adjustments in the price cap formula.
10

11 The Staff has recommended five criteria that the Commission should
12 consider¹¹. Numerous other criteria are discussed in the Addendum.
13

14 56. Q. Does this conclude your testimony?
15

16 A. Yes, it does.

¹¹ Pages 42 of the Staff Report of Investigation.

THE OHIO BELL TELEPHONE COMPANY
Case No. 93-487-TP-AIR
STIDC Tax Straight-Line Depreciation Adjustment
(000's Omitted)

(1)	Revised Jurisdictional Book Depreciation Expense (a)	\$ 265,404
(2)	Jurisdictional Unallowable Depreciation Factor (b)	<u>0.070193</u>
(3)	Adjusted Unallowable Depreciation (1) x (2)	18,630
(4)	Revised Jurisdictional Tax Straight-Line Depreciation (1) - (3)	<u>\$ 246,774</u>

(a) Staff Report

(b) Applicant's Additional Supplemental Workpaper WP ST-IS #24

THE OHIO BELL TELEPHONE COMPANY
Case No. 93-487-TP-AIR
Amortization of Excess Deferred Taxes Adjustment
(000's Omitted)

(1)	Revised Jurisdictional Tax Straight-Line Depreciation (a)	\$ 246,774
(2)	Excess Deferred Tax Factor (b)	<u>0.034059</u>
(3)	Jurisdictional Excess Deferred Taxes (1) x (2)	8,404
(4)	Factor to Adjust from 34% to 35% (c)	<u>0.914388</u>
(5)	Jurisdictional Excess Deferred Taxes Stated at 35% (3) x (4)	<u>\$ 7,685</u>

- (a) Direct Testimony of J. Edward Hess, JEH-1
(b) Applicant's Additional Supplemental Testimony Workpaper WP ST-IS #24
(c) Applicant's Additional Supplemental Testimony Workpaper WP ST-IS #20

CERTIFICATE OF SERVICE

I hereby certify that a true copy of the foregoing Prepared Testimony submitted on behalf of the Public Utilities Commission of Ohio was served by regular, U.S. mail, postage prepaid or hand delivered to the parties of record on this 12th day of July, 1994.


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