(Decision No. C92-854

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF COLORADO

* * *

REGARDING THE APPLICATION OF THE MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY, D/B/A U S WEST COMMUNICATIONS, INC., FOR APPROVAL OF THE RATE AND SERVICE REGULATION PLAN.	)	DOCKET NO. 90A-665T

FINAL COMMISSION ORDER

- - - - - - - - - - - - - - - - -
Adopted Date: May 26, 1992
Mailed Date: June 30, 1992
- - - - - - - - - - - - - - - - -

INTRODUCTION

This matter comes before the Public Utilities Commission ("commission" or "PUC") for consideration of U S West Communications, Inc.'s ("USWC" or "Company"), Application for Approval of its Rate and Service Regulation Plan. This application and the alternatives suggested by intervenors are referred to many times as "incentive regulation" or as "alternative form of regulation ("AFOR")."[1] The USWC incentive regulation application was filed on October 22, 1990. In

[1] Throughout this proceeding, the Commission and the parties have used the term "incentive regulation" as a shorthand reference for the alternative regulatory proposals suggested by the Company and various intervenors. As some of the testimony has pointed out, however, it is inaccurate to imply that traditional rate-of-return, rate-base regulation lacks incentives. For example, as Dr. Neil Langland of the PUC Staff noted in his testimony, traditional regulation, with its regulatory lag, actually provides incentives for efficiency between rate cases for regulated utilities including USWC. It is more accurate to state that the alternative regulatory proposals advocated by the parties in this case are intended to enhance operating efficiencies on the part of the Company (*e.g.,* motivate USWC to cut costs and engage in economically efficient investment) by changing the methods by which USWC rates and revenues are managed by this commission over the next few years.

accordance with commission Rules of Practice and Procedure, we gave notice of the filing of the application, and a number of parties intervened, including those parties who actively participated at the hearing: The commission staff ("Staff"), the Office of Consumer Counsel ("OCC"), The Colorado Municipal League and the Colorado Cable Television Association ("CML/CCTA"), MCI Telecommunications Corporation ("MCI"), AT&T Communications of the Mountain States ("AT&T"), and The Department of Defense and all other Federal Executive Agencies ("DOD").

A number of parties filed motions to dismiss. Generally, those motions argued that the commission lacked the requisite legal authority to grant the Company's application. We denied those motions in Decision No. C91-1293. *See* discussion, *infra*, regarding commission Authority to Implement Alternative Regulation, page 24. After the denial of the motions to dismiss, we proceeded to hearing beginning on October 21, 1991, and continuing on October 22 to 25, October 28 to November 1, and November 4 to 6, 1991. At hearing, Exhibits 1-114 were offered and admitted. A list of those exhibits is attached to this decision as the Appendix. Closing Statements of Position were filed on December 16, 1991. We held a number of public meetings to conduct our deliberations, with the final meeting occurring on March 12, 1992. Having considered all testimony and exhibits in this matter along with the Closing Statements of Position, we now issue our decision.

THE ORIGINAL APPLICATION FOR ALTERNATIVE REGULATION

The request for approval of an alternative form of regulation, as presented in the original application (Exhibit 13), proposed a number of modifications to traditional rate-base, rate-of-return regulation.[2] Components of the application included: The plan would apply to all Part 2 (fully regulated) and Part 3 (emerging competitive and flexibly regulated) services provided by the Company. *See* §§ 40-15-201 *et seq*., and 40-15-301 *et seq*., C.R.S. (1991 Cum. Supp.). The Company offered to freeze Part 2 rates (*e.g.,* rates for local exchange service) for the duration of the 5-year plan, except for certain automatic "exogenous pass-throughs." These pass-throughs included increases or decreases in federal, state, or local taxes; federally mandated changes in jurisdictional separations adopted by the Federal Communications Commission ("FCC"); surcharges to the Switch and Facilities Enhancement ("SAFE") and Rural Facilities Improvement Program ("RFIP") plans, any extensions or modifications to those programs, or any other commission-sanctioned program; and changes required to comply with accounting procedures promulgated by

[2] As discussed herein, the Company amended its original plan a number of times at hearing. Essentially, these modifications were intended to respond to criticisms of the plan presented by the intervenors. The Company's final proposal is set forth in the Statement of Modifications to Application filed on November 19, 1991. We discuss these modifications at page 8.

Financial Accounting Standards Board ("FASB") or Securities and Exchange Commission ("SEC") and included in the Uniform System of Accounts by the FCC.[3]

With respect to Part 3 service rates (*e.g.,* IntraLATA toll, switched access, and private line) the Company's plan would allow for pricing flexibility, within the discretion of the Company, subject to price floors and ceilings set by the commission. The Company suggested marginal or long-run incremental cost as the price floor, and the tariffed price set in the last rate case as the ceiling. The ceiling price would be subject to annual adjustment based upon the average annualized change in the GNP-Price Indicator for the preceding calendar year. The Company would be allowed to change rates within the band subject only to a 14-day notice. Price floors for toll would include an imputation for access charges. In addition, USWC could apply to the commission for revenue-neutral adjustments to price ceilings. Besides this pricing flexibility, the Company, under its plan, could contract with a customer for provision of any Part 3 service, regardless of the applicable banded prices, if the customer had competitive alternatives. Additionally, USWC would be authorized to make promotional offerings for Part 3 services, in which it deviated from the price bands, for up to 3 months in any calendar

[3] SAFE and RFIP are programs previously adopted by this Commission to improve rural telephone service. The SAFE program provides for conversion of electro-mechanical switches to digital-electronic switches. RFIP provides for upgrading of multi-party service to single- or dual-party service in certain exchanges. Both programs involve surcharges to rates. These surcharges are updated annually to reflect current expenditures.

year.

As a second element of the plan, the Company proposed a moratorium on all rate case proceedings during its term. No challenge to USWC earnings nor requests for rate relief by the Company, except for those contemplated in the application (*e.g.,* SAFE, RFIP, separations changes), would be entertained by the commission for a 5-year period. Even rate investigations on the part of the commission would be precluded by the proposed moratorium.

The USWC alternative regulation plan also contains a sharing mechanism in the event it earns over its authorized return on investment ("ROI").[4] Under the plan, a sharing threshold, 100 basis points above authorized ROI (11.71 percent), would be established. If the Company's earnings exceeded this threshold, the Company would "share" 50 percent of the excess with ratepayers by placing this amount in an extraordinary investment fund.[5] This ratepayer share of overearnings would be credited to the accounts in such a manner as to reduce the Company's net income by the ratepayers' 50 percent share. The other 50 percent of excess earnings would be retained by USWC for its shareholders.

As stated, the application suggests that ratepayers' share

---

[4] The terms "overearnings" or "excess earnings" in this Decision refer to earnings in excess of authorized return.

[5] We note that earnings under the plan would be measured by utilizing the Company's unadjusted Financial Reporting ("FR") books. That is, in measuring earnings, the ratemaking principles and accounting adjustment ordered by the commission when setting the revenue requirement would not be used.

of overearnings be used to fund extraordinary investments (*i.e.,* projects which would not be funded under the Company's normal capital budgeting process, most likely because of the anticipated low return). The application would have the commission establish a Committee on Investment Opportunities to evaluate and recommend uses for this extraordinary investment fund, subject to approval by the PUC.

To address concerns that, under incentive regulation, the Company may curtail investment in plant and facilities in order to improve earnings, the application proposes a baseline investment commitment. Essentially, this baseline commitment (*i.e.,* minimum investment during the duration of the plan) would equal: internally generated funds, defined as the net amount of funds for depreciation, deferred taxes, remaining investment tax credits, and non-funded pension accruals for the preceding calendar year (all amounts calculated from USWC's unadjusted FR books); and 50 percent of the amount of earnings generated between authorized ROI plus 100 basis points, less the Colorado intrastate portion of dividends to stockholders. Investments undertaken pursuant to this commitment would become part of rate base. (Notably, the extraordinary investment referenced above would not become part of rate base.)

To address additional concerns that under incentive regulation the Company might maximize profits at the expense of service quality, the application proposes certain financial incentives and penalties in the event quality of service exceeds or fails to meet certain standards. The original plan would measure quality of telephone service using 10 variables. Eight of the variables represent the percentage of residential and business customers giving the Company superior ratings on a customer survey (the Customer Service Measurement ["CSM"]) in the areas of provisioning, repair, billing, and general service. The other two variables are comprised of interexchange carrier blockage performance, measured by the percentage of trunk groups consistently at or near capacity, and customer trouble reports per 100 access lines. Both groups of variables would be adjusted over time to provide incentives to continue to improve service quality.

Based on these 10 factors, certain ranges for expected service would be established. If the Company's performance were to fall outside the ranges, indicating superior or inferior quality of service, the amount of overearnings available for sharing between USWC and ratepayers would be adjusted in increments of $500,000 for each variable. Superior performance by the Company on any one element would decrease the amount of excess earnings available for sharing by $500,000; inferior performance on any one element would increase the amount available for sharing by $500,000. In no event would the shared amount fall below zero (*e.g.,* the Company would not be required to return to ratepayers any earnings below the sharing threshold).

Another component of the Company's original AFOR plan involved an energy conservation incentive. If USWC's consumption of energy in a given year, adjusted to standard temperature, were less than base consumption (temperature adjusted 1989 levels), the Company would use base consumption expenses in calculating sharing amounts. So, reduced energy expenses (weather adjusted) would increase the Company's share of overearnings. This energy conservation award would occur only if earnings were sufficient to call for sharing.

These components of the original proposal are set forth in Exhibit 13, and are explained in the Company's direct testimony (Exhibits 1-4). As stated above, the application was modified throughout the course of the hearing. The Statement of Modifications explains the amendments made to the original plan.

AMENDMENTS TO THE APPLICATION

In response to intervenor criticism, USWC modified its plan in several respects. First, PUC Staff and the Company entered into a stipulation (Exhibit 41) regarding service quality measurements, weightings, and performance objectives (the "Stipulation"). See Quality of Service discussion, *infra*, for description of Exhibit 41 provisions. We simply note here that the service quality measurements originally proposed in the application were replaced by the stipulation.[6]

The manner in which quality of service scores would affect earnings and sharing under the alternative regulatory scheme was also modified. Generally, under USWC's amendment a service quality score would be calculated using the measures, objectives, and weightings specified on Exhibit 41. If that calculation produced a net negative score, any earnings above authorized ROI of 11.71 percent would be reduced by the number of basis points equal to that score. For example, if the Company earned 100 basis points in excess of 11.71 percent ROI and the net negative service quality score were -20 (from Exhibit 41), the Company would share 20 basis points with ratepayers and retain the remaining 80 basis points.[7] If the service quality score were positive, sharing would occur as originally proposed (*i.e.,* the Company would retain the first 100 basis points above its authorized ROI, and 50 percent of all earnings above 12.71 percent ROI).

Next, the application was modified to preclude automatic, exogenous pass-throughs, except for surcharges related to SAFE, RFIP, any extensions of those programs, and any other commission-sanctioned programs. (In the original application, the exogenous pass-throughs were automatic, *i.e.,* without hearing.)

[6] The stipulation between USWC and Staff did not resolve all service quality issues. For example, Staff continued to oppose CSM as a measure of customer satisfaction with the Company's service. In addition, the two parties continue to disagree regarding the effects of quality-of-service on sharing amounts. *See* discussion, *infra*.

[7] Without the quality of service adjustment, the Company would retain all 100 basis points of overearnings.

The Company, in the modifications, still reserved the right to request rate increases associated with post-retirement accounting changes, as exceptions to the rate freeze under its AFOR plan. Any such increases could be spread to Parts 2, 3, and 4 (deregulated) services. Additionally, ceiling prices for Part 3 services affected by a post-retirement-benefits change would be increased.

Other than these amendments, the Company's suggested incentive regulation scheme remained unchanged from the original application. No intervening party assented to the USWC plan, even as modified. Some of the parties offered suggestions to further modify the Company's proposal, while others proffered their own wholly integrated plans.

INTERVENORS' PROPOSALS

DOD Plan. In Exhibit 17, witness Charles W. King, presented DOD's incentive regulation proposal. That plan establishes a "deadband" of 100 basis points around the Company's authorized ROI. This deadband is so-named inasmuch as only the presence of earnings outside of the deadband--the deadband being 50 basis points above or below authorized ROI--would result in a "sharing" between ratepayers and the Company. When semi-annual financial reports, consisting of 9 months actual and 3 months forecasted data, indicated that the Company's return fell outside the deadband, a sharing mechanism would be implemented contingent upon the Company meeting minimum service quality standards. Unlike the Company's plan, the DOD proposal "shares" overearnings, not by a refund to ratepayers, but by prospective rate adjustments.[8] If the Company's reported earnings rose above the deadband range, rates would be reduced by an amount representing earnings above the deadband threshold times a multiplier reflecting the extent to which the Company's growth in total factor productivity ("TFP") performance exceeded that of all Bell Operating Companies ("BOCs").[9] The more the Company's TFP growth exceeded that of the BOCs, the less rates would be reduced. Conversely, if the Company's reported earnings fell below the deadband, rate increases would be limited to the amount representing the increase necessary to bring earnings up to the lower limit of the deadband times a productivity multiplier reflecting the extent to which the Company's growth in total factor productivity performance fell short of that of the BOCs. The more USWC's TFP growth fell below that of the BOCs, the less would rates be increased.

Under the DOD scheme, the commission would develop two lists of services, one comprised of services subject to rate increases if ROI were to fall below the deadband, and one comprised of services whose rates would be decreased if ROI were to rise above

---

[8] DOD's plan also "shares" underearnings by prospective rate increases.

[9] TFP equals an output index divided by an index of <u>all</u> inputs used in the production process.

the deadband. The two lists would be determined based upon the services' cost and price relationships. For example, services purportedly priced below cost would be placed upon the list of services subject to rate increases.[10] Each list would reflect an established priority, along with dollar amounts, of services whose rates would be affected by the sharing of overearnings. If ROI fell within the deadband twice in a row, the Company would be permitted to change rates on the two lists if the net revenue effect were zero, and the changes on either list were less than $10 million.

The DOD plan would be contingent upon maintenance of adequate service standards. Failure to achieve a minimum level of service quality would result in a refund of earnings above the commission's most recently authorized ROI, a reduction in rates to the authorized return level, or a denial of rate increases in the event earnings were below the authorized return.

<u>CML/CCTA Proposal</u>. CML/CCTA's primary position is that many elements of any incentive regulation plan are illegal and may not be adopted. Furthermore, CML/CCTA argued that the evidence in this proceeding has not indicated that any alternative to traditional rate-base, rate-of-return regulation is necessary. CML/CCTA argue in the alternative that, if their arguments

[10] Basic exchange would be placed on the list of services whose rates would be subject to increase. However, basic exchange rates could not increase faster than the Consumer Price Index.

regarding the legality of any incentive regulation plan are rejected, their plan is the most appropriate. We will discuss the legal and other predicate issues raised by CML/CCTA, *infra*. Here we describe the CML/CCTA plan.

The CML/CCTA plan was presented in the direct testimony of witness Jamshed K. Madan (Exhibit 39), and is in essence the incentive regulation scheme adopted in the State of Georgia. The basic elements of the plan are: minimum service quality standards should be met before the Company receives any benefits from an incentive plan. CML/CCTA adopted the minimum service quality standards recommended by the OCC. USWC would also be required to attain minimum operating efficiencies before receiving any benefits. Whether these efficiencies were achieved would be measured by growth in TFP. CML/CCTA suggest that the Company be required to achieve at least a 4 percent growth rate in TFP before participating in plan benefits. If these two thresholds (growth in TFP and quality of service) are met, sharing of overearnings occurs according to a sharing matrix attached to Mr. Madan's testimony. Using Mr. Madan's matrix, the Company's share of earnings over authorized return on equity ("ROE") would vary from 0 to 50 percent depending on its growth in TFP.[11] Sharing would occur only after a deadband was exceeded, and all earnings beyond a certain point would be returned to ratepayers. Ratepayers'

[11] This summary of the various proposals points out that some of the plans use ROE and some use ROI as the sharing threshold.

share of excess earnings would be returned in the form of a refund and a prospective rate reduction.

CML/CCTA suggest that any plan implemented should last no longer than 3 years, with the commission being able to terminate the plan at any time. In commenting upon the USWC proposal, CML/CCTA argue that exogenous pass-throughs, as well as any other rate increases, be precluded under any plan. No flexible pricing for any service should be allowed, baseline investment commitments should be eliminated from any incentive proposal, and the commission must retain its rate complaint jurisdiction along with its authority to institute show cause proceedings regarding Company earnings.

OCC Plan. Like CML/CCTA, the OCC also asserts that the commission lacks the legal authority to institute incentive regulation, and that its plan should be considered only if this argument is rejected.[12] Before any plan is implemented, the OCC contends, the Company must first comply with existing quality of service rules to ensure customers are receiving adequate service. Under the OCC's formulation of alternative regulation, the sharing threshold is 11.11 percent ROI.[13] Under the OCC's plan,

---

[12] The OCC's position was presented in the testimony of witnesses Ronald J. Binz, William Page Montgomery, and Dian Callaghan. *See* Exhibits 14, 14A, 15, 16, 16A, and 20.

[13] As discussed, *infra*, the OCC and USWC disagree as to the specific ROE which has been established by this commission. The OCC's sharing threshold of 11.11 percent ROI is based upon an authorized return on equity of 12.5 percent. The Company's threshold of 11.71 percent ROI is based upon a 13.5 percent authorized

ratepayers would receive the first 50 basis points of earnings in excess of authorized ROI, and an additional automatic (*i.e.,* not dependent upon USWC earnings) annual refund to ratepayers in the amount of $3.5 million. This "consumer dividend" is intended to compensate customers for embedded efficiencies in the Company which the OCC argues have been previously funded by ratepayers. Once ratepayers receive this first share, the next 200 basis points of overearnings would be retained by the Company. Earnings in excess of 2.5 percent above authorized ROI would be returned in their entirety to ratepayers, and the commission would re-examine the plan to determine if modifications were necessary.

Customers' share of overearnings would be returned in the form of refunds <u>only to Part 2 ratepayers</u>. Therefore, under the OCC scheme, Part 3 service customers (*e.g.,* toll and interexchange providers who purchase switched access from the Company) would not share in refunds of overearnings.

Generally, the OCC recommends the use of two service quality measures during the first year of the plan, held orders and number of trouble reports per 100 access lines. Rewards and penalties would be based upon USWC improvement in these two areas over the term of the plan [3 years]. Additionally, the OCC proposes that during the first year of the plan, interested parties such as Staff, the Company, and the OCC would jointly develop service quality measures, both objective and subjective standards, a new

---

ROE. We discuss that issue at page 38.

measure of customer perception of service quality, and the appropriate weightings of those measures. These new standards would be implemented in the second year of the plan and would continue.

Other significant aspects of the OCC proposal include:

1. The Company would be granted pricing flexibility for Part 3 services, with the exception of toll. [Toll rates could be decreased by less than or equal to 5 percent, but could not be increased unless it could be proven that market conditions warranted such an increase. If toll rates were raised, residential toll rates could not be increased more than the average increase of all other toll rates.] This flexibility, both upward and downward, would vary up to 5 percent per year during the term of the plan. Prices for Part 3 services could not go below long-run incremental costs.

2. No moratorium on rate cases would be adopted. During the term of the plan [3 years], any authorized party, including the Company, could initiate a proceeding concerning rates and USWC earnings.

3. Automatic pass-throughs, investment commitments, and conservation incentives, would not be part of any incentive plan. The OCC, like most of the other parties, strongly opposed these elements of the USWC proposal.

Staff Plan. Like the OCC and CML/CCTA, Staff opposes incentive regulation for both legal and policy reasons. Staff's proposal is offered for consideration only if these legal and policy arguments are not accepted. In this section of the opinion we merely describe the plan. Discussion of Staff's arguments regarding the commission authority to adopt an alternative form of regulation is at page 24, *infra*. (Staff's position is set forth in prefiled direct testimony of witnesses Jorgensen, Wendling, Hunt, Mitchell, Cunningham, Williams, Berry, and Langland, Exhibits 5-12A.)

Generally, Staff's plan incorporates a sliding scale for the authorized ROE between 11.5 and 15.5 percent. USWC's authorized ROE would vary within this range depending upon a productivity measurement (cost per access line as compared to commission established goals) and quality of service ratings.[14] The Staff plan would operate in this manner:

1. USWC's quality of service (using criteria and weightings from Exhibit 41) would be calculated. A negative rating would be subtracted from 12.5 percent ROE up to a maximum of 100 basis points. This calculated ROE would become the Company's authorized return for purposes of the plan. If authorized ROE were greater than actual earned ROE (measured by using commission and accounting adjustments), no sharing would occur. The Company would retain all earnings. If authorized ROE were less than actual earned return, the entire difference would be returned to ratepayers in the form of a rate rollback; or[15]

2. If the overall service quality rating were non-negative, but contained one or more negative scores on specific factors, the overall rating would be added to 12.5 percent ROE to determine the authorized return. Any earnings in excess of authorized return would be returned to ratepayers in a rate rollback; or

[14] Originally, Staff (Exhibit 8) suggested a service quality plan composed of 17 variables (*e.g.*, total trouble reports per 100 lines, repeated trouble reports per 100 lines, held service orders, etc.), with different relative weights assigned to each variable. *See* Staff-Mitchell-Exhibit 1 attached to Mitchell direct testimony. As noted*, supra*, Staff and the Company subsequently agreed to the service quality standards set forth in Exhibit 41. However, Staff does not support use of CSM except as an interim measure.

[15] At hearing Staff suggested that the ratepayers' share of overearnings be returned either by refund (*i.e.*, a credit to customers' bills), or through a prospective rate reduction. However, in its closing statement of position, Staff modified its position to provide only for prospective rate adjustments. Apparently, Staff believes that any refund mechanism would constitute unlawful retroactive ratemaking.

3. If the service quality rating were non-negative and contained no negative individual scores, costs per access line would be compared to preset goals. If the ratio of cost per access line to preset goals (Staff-Jorgensen-Exhibit 3, page 2) were between 95 and 105 percent, 13.5 percent ROE would be used for purposes of further calculations to determine authorized earnings. A ratio below 95 percent (indicating the Company exceeded productivity goals) would increase ROE, for purposes of further calculations, .2 percent for every 1 percent below 95 percent. Ratios above 105 percent (indicating the Company did not meet productivity goals) would decrease ROE by the same amounts. For example, a cost-per-access-line-as-percent- of-goal score of 90 percent would increase ROE to 14.5 percent; a score of 110 percent would decrease ROE to 12.5 percent. The quality of service score, equal to or less than 100 basis points, would be added to the ROE derived from the cost per access line measure. This final ROE would be the authorized return. Only those earnings in excess of the authorized ROE would be returned to ratepayers in the form of a prospective rate reduction.

Staff's plan, in general, would allow the Company's authorized earnings to fluctuate between 11.5 and 15.5 percent ROE depending upon productivity and quality of service.

Staff also opposed a number of aspects of the USWC proposal. In part, Staff stated that no pricing flexibility for Part 3 services should be granted in this docket; earnings should be measured utilizing commission and accounting adjustments; no investment commitments (either baseline or extraordinary investment) should be incorporated into the plan; and no automatic pass-through mechanism should be approved.

Other Intervenor Comments

Instead of offering their own wholly integrated proposals, AT&T and MCI suggested modifications to the plans offered by USWC and others. We now describe the general positions taken by these two parties.

AT&T. To begin, we note that AT&T supports the concept of incentive regulation for the Company, provided that appropriate safeguards are included in the plan. (AT&T's positions were presented in prefiled testimony, Exhibits 21-23.) AT&T states that, inasmuch as USWC possesses monopoly power for certain services, we should proceed carefully and deliberately in departing from traditional regulation. Any AFOR scheme must, according to AT&T, guard against potential abuses such as cross-subsidization, price discrimination, and "perverse pricing." AT&T then suggests that the safeguards needed in any plan include: a fully distributed cost allocation manual separating regulated from deregulated services; a long-run incremental cost test for each service; a cap on monopoly service rates; tariffed rates for monopoly services; prices related to costs; services available on reasonable demand; employment of ratemaking adjustments (*e.g.,* when measuring earnings); elimination of all prohibitions on resale and sharing of services from the USWC tariff; required filing of appropriate financial reports; and adoption of tariff guidelines prior to implementation of any AFOR plan.

Primarily, AT&T's concern in this proceeding was how any incentive regulatory plan would affect carrier switched access, and most of its testimony was related to this fundamental issue. AT&T requests that the commission explicitly acknowledge that carrier access is a monopoly service, and that the service be treated accordingly in any adopted plan. We note that virtually all testimony at hearing agreed that USWC's carrier access is primarily a monopoly service. We accept this testimony as credible. However, we note that many of the safeguards suggested by AT&T relate to costing and pricing issues which have been taken up in Docket No. 92M-039T.

Consistent with the positions of many other parties, AT&T emphasizes that any AFOR plan must incorporate quality of service standards to guard against a deterioration of service while higher earnings are pursued. AT&T emphasized five standards for measuring service quality for carrier access. These are: installation commitments, on-time installations, restoration of failed circuits, call blockage, and customer trouble reports. *See* testimony of witness Barrett Zahn.

With respect to overearnings under incentive regulation, AT&T suggests that we place a limit on the amount the Company would be allowed to retain. AT&T submits 16.5 percent ROE as one possible cap and recommends a 50-50 sharing between authorized ROE and a 16.5 percent return. According to AT&T, all earnings in excess of the limit should be returned to ratepayers--including, of course, carrier switched access users. AT&T opposes the proposals made by parties such as the OCC and USWC that only Part

2 ratepayers would participate in any refund.[16] In support of its position that interexchange carriers participate in any sharing of excess earnings, AT&T commits to flow through to its customers any monies received from USWC relative to carrier access services. AT&T reserves only the right to request that the commission modify the flow-through commitment based upon future financial and other considerations.[17]

Other elements of the AT&T case included: strong opposition to use of ratepayers' share of overearnings to fund an extraordinary investment program for USWC; insistence that ratemaking principles be utilized in financial reports under the plan; opposition to pricing flexibility for Part 3 services; and, resistance to price changes, even revenue-neutral price changes, to Part 3 offerings while the plan is in effect, except through normal commission procedures. AT&T opposes any flexible pricing for access services, even revenue-neutral flexible pricing for the duration of the plan. According to this position, prices for all monopoly services would be capped for the term of the plan and would be increased only with permission from the commission employing existing, applicable procedures (*e.g.,* advice letter filings). For example, the local transport rate element of

---

[16] Carrier access has been classified as a Part 3 offering in § 40-15-301, C.R.S. (1991 Cum. Supp.).

[17] The AT&T flow-through offer is phrased in terms of monies refunded from the Company. In light of our decision not to refund monies, but instead to adjust rates prospectively to account for USWC overearnings, we interpret this offer to apply also to sharings AT&T receives in the form of decreased rates.

carrier access could not be unilaterally decreased by the Company as an offset to an increase in the local switching rate element. These issues are discussed, *infra*.

MCI. MCI's position is set forth in the testimony of Dr. Nina Cornell, Exhibits 37-38. Generally, MCI opposes incentive regulation unless certain components to promote efficiency on the part of the Company are included. MCI opposes most of the elements of the plan offered by USWC. Insofar as the sharing mechanism is concerned, MCI contends that the sharing threshold should be the authorized return, and no deadband--as suggested by the Company-- should be included. In order to preclude windfall profits to USWC and encourage increased Company efficiency, MCI suggests that a "reverse taper" be included as a component of any plan. This element would give most of the initial overearnings to ratepayers, with the Company retaining a greater share as earnings increase. Dr. Cornell recommended that the first 100 basis points of excess earnings be split 80 percent-20 percent, with ratepayers getting the lion's share. The next 100 basis points would be shared with as much as 50-60 percent being returned to consumers. Only 40-50 percent of the next 100 basis points would go to ratepayers.

Like AT&T, MCI asserts that all customers of the Company, including interexchange carriers, should share in the return of overearnings. MCI argues that since carrier access is a monopoly service, and since all ratepayers would contribute to overearnings, all should share in the benefits of incentive regulation. In short, MCI disfavors the OCC's position that only Part 2 customers share in overearnings.

Consistent with the views of most of the parties, MCI resists both the extraordinary investment concept and the baseline investment commitment proffered by the Company. Dr. Cornell asserts that it would be inefficient not to allow ratepayers to choose how to spend their own monies. Additionally, MCI suggests it would be anticompetitive to allow USWC to retain overearnings, collected, in part, from its competitors (*e.g.,* interexchange carriers), and to invest those funds in facilities which would be used to compete against those same competitors. Such action, according to MCI, would amount to exploitation of the consumers' share of overearnings. As for the baseline investment commitment, MCI warns that this component of the Company's plan could lead to uneconomic investments and overinvestment in the rate base. MCI favors continuation of present policy. That policy requires USWC to invest sufficiently to achieve acceptable service quality. In addition, the Company is free to make other investments which are economic.

With respect to service quality under incentive regulation, MCI states that these standards should be objective and objectively measurable. Consistent with this position, MCI opposed use of the customer service surveys suggested as part of

USWC's initial filing. MCI generally agreed with AT&T's and the OCC's criticisms of the Stipulation. This position calls for changes and additions to the Stipulation between Staff and the Company before use in an AFOR plan.

MCI also contends that pricing flexibility for Part 3 offerings should not be granted as part of this proceeding. Before any pricing flexibility is approved, MCI argues, the commission must ensure that price squeezes and cross-subsidization of competitive services by monopoly services will not occur. To accomplish this, MCI contends that the commission should implement Dr. Cornell's "building blocks" proposal.[18] MCI opposes a rate case moratorium except as to overall earnings of the Company. Challenges to specific rates (*e.g.,* a rate believed to be anticompetitive by a complainant) should not be precluded. Finally, MCI, like most parties, supports the use of ratemaking principles and accounting adjustments to establish USWC's earnings in an AFOR plan.

COMMISSION AUTHORITY TO IMPLEMENT ALTERNATIVE REGULATION

By way of motions to dismiss, motion for summary judgment, and argument in closing statements of position, various parties have challenged the commission's authority to adopt an incentive

[18] In general, the building blocks proposal calls for breaking down the functions provided by USWC's network to their basic functional components. Once the basic components are determined, Dr. Cornell would have the commission make costing and pricing determinations on the basic functional components themselves, and set price floors for USWC services based upon these determined costs.

regulation plan. The commission, in Decision No. C91-1293, denied the motions to dismiss. However, based upon the evidentiary record established at hearing, some of the parties have renewed their requests for dismissal. No new arguments are advanced in the closing statements or in Staff's Motion For Summary Judgment, and the commission hereby reaffirms its previous ruling that it possesses the authority to implement incentive regulation.

The requests for dismissal raise a host of issues concerning the commission's authority to depart from traditional regulatory mechanisms, as well as the commission's power to adopt some of the components of the various plans. These issues include: whether the commission has the authority to adopt any scheme which would allow the Company to retain earnings over its predetermined rate of return; whether the commission may allow "excess earnings"; whether the commission may legally allow the Company to retain "excess earnings" as part of an extraordinary investment fund; whether the commission may commit to a moratorium on rate case proceedings for U S West as part of any plan; whether the commission may incorporate retroactive ratemaking as a component of a plan, even with Company agreement; whether the commission may adopt any proposal outside of a rulemaking proceeding; and whether an order issuing from this proceeding may grant blanket flexible regulation or pricing flexibility for Part 3 services of the Company. As previously noted, Decision No. C91-1293 disposed of many of these issues, and the commission here reaffirms that ruling. For clarity of the record, however, these issues are reexamined and discussed in the present decision.

General Challenge To Incentive Regulation. Some of the intervenors' arguments are broad challenges to the commission's power to adopt any of the incentive plans. Essentially, these challenges are based on the contention that the commission lacks the legal prerogative to depart from traditional methods of regulation. Arguments that the Company cannot be allowed excess earnings, that the Company may not retain any portion of excess earnings, or that excess earnings may not be used for an extraordinary investment fund fall into this category. The proponents of this position have misapprehended the commission's legal authority--indeed responsibility--and mischaracterized the various AFOR proposals, especially as compared to present regulation. The commission, therefore, rejects these arguments.[19]

We begin by considering the nature of our legal authority. Article XXV of the Colorado Constitution effectuated a broad delegation of legislative power to the PUC, vesting it with as much authority as the general assembly had prior to the adoption

[19] In light of the AFOR plan adopted in this decision, we need not address some of the legal challenges made by various parties. For example, since we are not approving the Company's proposal to place ratepayers' share of overearnings in an extraordinary investment fund, we do not address the arguments that the Commission lacks the authority to approve extraordinary investments, that ratepayers' share of overearnings are legally required to be refunded to them, that the commission was impermissibly involving itself with management of the Company, etc. Additionally, since we are requiring ratepayers' share of overearnings to be "returned" to them in the form of a prospective rate adjustment, we do not address whether the Company could voluntarily and lawfully agree to retroactive ratemaking.

of the Article. The commission's authority under Article XXV is not narrowly confined but extends to incidental powers which are necessary to enable it to regulate public utilities. Mountain States Tel. & Tel. v. Public Utilities Commission, 763 P.2d 1020 (Colo. 1988); Colorado-Ute Elec. v. Public Utilities Commission, 760 P.2d 627 (Colo. 1988). The Colorado Supreme Court has held that the power of the commission is equivalent to that of the Legislature, except as limited by statute. Colorado Energy Advocacy v. Public Service Company, 704 P.2d 298 (Colo. 1985). Because the power vested in the commission is legislative in nature, the PUC has considerable discretion in its choice of the means to accomplish its functions. Public Service Company v. Public Utilities Commission, 644 P.2d 933 (Colo. 1982); City of Montrose v. Public Utilities Commission, 629 P.2d 619 (Colo. 1981). Therefore, as an initial observation, we reject any suggestion that the commission is unable to adopt any regulatory mechanism which is not expressly and explicitly provided for in statute.

As noted, *supra*, the essential proposition of those who broadly and generally challenge the commission's power to implement alternative regulation is that the PUC lacks authority to depart from traditional rate-base, rate-of-return regulation. It is now well-established that this proposition is false. *See* Public Service Company, *supra* (commission has the authority to permit cost adjustments such as the gas cost adjustment as part of its wide discretion to govern and regulate rates); Office of Consumer Counsel v. Public Utilities Commission, 752 P.2d 1049 (Colo. 1988) (commission need not consider test year data before allowing a rate increase to go into effect). In short, the requests for dismissal do not properly account for this commission's comprehensive and far-reaching power to regulate public utilities, whether or not specific methods of regulation are stated in the statute.

We also observe that the motions for dismissal mischaracterize the effect of the alternative regulatory proposals in a situation of overearnings, especially as compared to present regulation. Various intervenors argue that it would be unlawful to allow the Company excess earnings (*i.e.,* earnings over authorized return) or to allow the Company to retain excess earnings.[20] The commission notes that USWC rates presently in effect were set in Docket No. 90S-544T after full hearings, and utilizing traditional regulatory principles (*e.g.,* revenue requirement was determined based upon test year data, ratemaking adjustments were made to Company numbers, appropriate rate of return was determined). Those rates were not adjusted upward to allow the Company additional earnings. Moreover, the Company has not proposed any increase in rates in the present proceeding.

[20] This mischaracterization may be due, in part, to the Company's proposal to place a moratorium upon rate cases for the duration of the alternative regulatory plan. However, in Decision No. C91-1293 we made clear that such a moratorium is beyond our legal authority. This decision reaffirms that ruling.

Therefore, it is incorrect to state that present rates--the rates to be in effect during the term of the adopted plan--impermissibly allow for overearnings.

It is helpful to compare the disposition of overearnings under the plan adopted here to traditional regulation. Under conventional regulation, which incorporates regulatory lag, the Company is entitled to keep all earnings, including those in excess of authorized return, until the commission can reset rates in accordance with proper procedure. This would likely involve a fully litigated hearing brought before the commission by the Company, through a show-cause initiated by Staff, or as the result of a filed complaint. Credible testimony in this proceeding indicated that regulatory lag (*i.e.,* that period of time which would elapse before the commission could reset Company rates due to earnings in excess of allowed return) is approximately 18-24 months. Unlike present regulation, the plan adopted here would result in a sharing between the Company and ratepayers of earnings in excess of authorized return without a fully litigated rate case likely sooner than under traditional regulation. In summary, under the traditional regulatory regime, it is incorrect to characterize all utility earnings above the authorized return as ratepayer monies. Regulatory lag, in conjunction with the legal prohibition against retroactive ratemaking, make that characterization inaccurate.

Necessity for Rulemaking. Several of the parties have suggested that the implementation of incentive regulation is by its nature rulemaking, and, therefore, no relief can be granted without compliance with rulemaking procedure. *See* § 24-4-103, C.R.S. (1988). Since this rulemaking contention primarily was directed at the Company's request for pricing flexibility for all its Part 3 services, and since this issue has been severed from this docket and placed into the Costing and Pricing proceeding recently established by the commission (Docket No. 92M-039T), this argument is moot. However, so that no doubt remains, we expressly reject any assertion that the plan adopted here must be the subject of rulemaking.

The commission is cognizant of those decisions which can only be made in a rulemaking proceeding. Matters of <u>general</u> applicability and future effect implementing agency policy are appropriately determined by rule. <u>Colorado Office of Consumer Counsel v. Mountain States Tel. and Tel.</u>, 816 P.2d 278 (Colo. 1991). We emphasize that the regulatory mechanism adopted in this order applies <u>only</u> to USWC. Moreover, we observe that the decisions made here (*i.e.*, how the Company's rates and earnings will be determined for the duration of this plan) are essentially ratemaking matters. This commission has historically, without objection from the courts, made ratemaking determinations for individual utilities outside of rulemaking. No reason exists in the present matter to depart from this long and well-considered precedent.

Pricing Flexibility for Part 3 Services. As noted, *supra*, issues relating to pricing and other regulatory flexibility for the Company's Part 3 services will be taken-up in the Costing and Pricing Docket. For guidance to the parties in that proceeding, we note that the existing Part 3 rules, 4 CCR 723-24, set forth the "exclusive" means by which relaxed regulation (*e.g.,* pricing flexibility) may be granted. Those rules do not contemplate a blanket order authorizing flexible regulation, but rather, require a product-specific inquiry.[21]

However, we do not agree with the argument advanced by some of the parties that there is a statutory prohibition against such a blanket order. The statute cited in support of this contention is § 40-15-302(1), C.R.S. (1991 Cum. Supp.) which provides:

> [T]he commission shall promulgate . . . rules and regulations as may be appropriate to regulate services and products provided pursuant to this part 3. In promulgating such rules and regulations, the commission shall consider such alternatives to traditional rate of return regulations as flexible pricing, detariffing, and other such manner and methods of regulation that are deemed consistent with the general assembly's expression of intent pursuant to section 40-15-101. It is the intent of the general assembly that traditional rate base or rate of return regulation may be considered but shall not be the sole factor considered by the commission. . . .

Nothing in these provisions indicates that the commission may grant flexible regulation, such as pricing flexibility, only on a product-specific basis. While the rules which were adopted

[21] To the extent any prior orders of the commission suggest the contrary, we now modify that view.

to implement § 40-15-302(1), C.R.S., (*i.e.,* 4 CCR 723-24) presently require such an examination, we do not interpret the statute as precluding a change to the rules. In any event, this issue undoubtedly will arise in the Costing and Pricing Docket. Of course the parties in that proceeding are free to address the commission's authority to change the rules, so as to allow pricing flexibility for Part 3 services on other than a service-by-service basis.

Rate Moratorium. One component of the USWC proposal was to place a moratorium upon Company rate cases for the term of the plan. In Decision No. C91-1293, we held that such a moratorium would be legally impermissible. We now reaffirm that ruling. The Public Utilities Law, § 40-6-108, C.R.S. (1984), expressly allows certain entities and parties to initiate proceedings concerning utility rates, and mandates that the commission hear such complaints. In addition, we have previously held that the OCC is statutorily empowered to initiate such proceedings. *See* § 40-6.5-106(2), C.R.S. (1984). This commission is also obligated to regulate Company rates and earnings, and cannot abdicate that responsibility. *See* §§ 40-3-101, 102, C.R.S. (1984). In short, we cannot adopt a moratorium on rate cases for the Company as part of any incentive regulation plan.

Retroactive Ratemaking. The parties correctly note that there are limitations upon the commission's authority to adopt a plan which involves retroactive ratemaking. *See* Colorado Energy Advocacy, *supra* (law is improperly retroactive in operation if it takes away or impairs vested rights acquired under existing laws, imposes a new duty, or attaches a new disability in respect to transactions or considerations already past). We note that several of the plans offered by the parties do involve retroactivity as a component (*e.g.,* the proposals of USWC and the OCC).

However, we do not agree that the plan adopted here is impermissibly retroactive. As noted on page 42, the plan adopted here will return ratepayers' share of excess earnings to them by a prospective rate adjustment instead of through refund. This sharing mechanism avoids any potential illegality associated with retroactive ratemaking. We note that in Colorado Energy Advocacy, *supra*, the Supreme Court upheld the legality of the gas cost adjustment ("GCA") against a challenge that it was impermissibly retroactive. The GCA approved in that case operated, in part, by adjusting monthly gas rates to account for the under- or over-recovery of actual gas costs incurred two months previously. However, the adjusted gas rates were applied only prospectively (*i.e.*, to future sales). Against a claim that the GCA was unlawfully retroactive, the Supreme Court held: "The GCA tariff does not impair a vested right or impose a new duty with respect to past transactions, for the tariff as imposed applies only to future gas consumption. Such a tariff does not constitute retroactive ratemaking." Colorado Energy Advocacy, *supra*, at 305.

Our adopted plan will result in decreased rates if the Company earns over its authorized return. The proposals of various parties to refund past earnings do involve retroactive ratemaking. The Company proposed to waive its right to challenge such retroactivity, if the adopted plan was otherwise acceptable. We need not decide whether such a waiver is lawful. In order to avoid even the appearance of illegal retroactivity, we are adopting a sharing mechanism which will return ratepayers' share of overearnings by prospective rate reductions.

JUSTIFICATION FOR INCENTIVE REGULATION

Some of the parties opposing incentive regulation contend that, in order to depart from the traditional regulatory scheme (*i.e.,* rate-base rate-of-return), we must first find that present methods have become inadequate. For example, CML/CCTA argue that the proponents of AFOR carry the burden of proving that the existing regulatory treatment of the Company is no longer just and reasonable. In support of this argument, CML/CCTA and others cite those cases which hold that proponents of changes to rates must initially prove that existing rates are unlawful. We believe these arguments misstate the standard of proof in this case.

In the first place, we emphasize that this proceeding does not directly involve a change to the Company's rates. Except for requesting pricing flexibility for Part 3 services, USWC did not, as part of its application for alternative regulation, propose new rates. Moreover, the alternative regulatory scheme we adopt here does not directly involve a change to rates. In short, the present proceeding is not a rate setting case.[22] Thus, those cases relating to burden of proof with respect to ratemaking are inapposite.

The incentive plan we adopt in this decision is a moderate change to the traditional means we have employed to regulate USWC's earnings. Instead of readjusting the Company's earnings and rates, in a case of overearnings, through formal hearings, the plan we are approving here will decrease those rates without hearing and the delay associated with formal process. We acknowledge that this incentive scheme is a departure from longstanding methods of regulating utility earnings. As such, we bear the burden of explaining the reasonableness of this departure from established practice, and that explanation must be supported by evidence in the record. Colorado-Ute Elec. v. Public Utilities Commission, 760 P.2d 627, 639 (Colo. 1988) (commission not bound by *stare decisis*; while consistency in administrative rulings is essential, appearance of arbitrariness is dispelled when new

[22] We recognize that the incentive regulation we approve in this decision may result in decreased rates in the future if the Company earns in excess of the sharing threshold. However, this would be the future result of the new regulatory framework and future Company overearnings.

findings are made on the basis of the evidence). Accord: A.F.L.-C.I.O. v. Dole, 923 F.2d 182 (D.C. Cir. 1991) (agency is entitled to change its existing policy so long as it supplies a reasoned explanation for its choice); Columbia Gas Transmission v. Fed. Energy Reg. Comm., 628 F.2d 578 (D.C. Cir. 1979) (Federal Energy Regulatory Commission bears the burden of explaining departure from longstanding Seaboard formula for rate design, and any facts underlying its explanation must be supported by substantial evidence). City of Alma v. United States, 744 F. Supp. 1546 (S.D. Ga. 1990) (agency is not forever bound by its prior determinations, as its view of what is in the public interest may change; agency must give a reasoned explanation for its departure from precedent). We find that the case for alternative regulation has been supported by substantial, reasoned evidence.

First, we note that the telecommunications industry is now more competitive than it has been in the past when traditional regulation was developed. Various parties may disagree as to how much competition is present, but none should dispute that the industry is now more competitive. Indeed, the State Legislature, in reliance on this increasing competition, enacted Article 15 of Title 40, which flatly deregulated some telephone services and directed us to flexibly regulate other services which were found to be emerging competitive services. We accept that testimony in the present proceeding which suggests that there is competition in USWC markets, and that the degree of competition in those markets will increase in the future. *See* Harris direct testimony.[23]

A regulatory scheme which gives the Company incentives to increase earnings and efficiencies will allow it to continue to meet its obligations in increasingly competitive markets. While regulatory lag does provide some incentives to efficiency--the utility is entitled to retain all earnings between rate proceedings--the threat of a rate case in the event of increased profits is real. A regulatory regime which reduces the possibility of fixed rate and earnings reductions as a penalty for greater utility efficiency provides more appropriate incentives.[24]

Although the notion is inaccurate in significant respects, traditional regulation has been viewed by many, including utility managers and employees, as a cost-plus system. A scheme which freezes rates and gives the Company the opportunity to earn higher profits with a lessened threat of fixed rate reductions will send different signals to USWC management and employees as compared to present regulation. The appropriate balance will provide benefits for the overall achievement of the goals of public utility regulation (*i.e.*, safe and reliable utility services <u>to all</u> on

---

[23] We do not make findings here as to whether competition is or will be as pervasive as the Company contends.

[24] We recognize that, in light of our inability to impose a rate case moratorium, we cannot guarantee there will be no rate cases under incentive regulation. However, we have no doubt that, with ratepayers sharing in overearnings and regulatory lag reduced, the likelihood of such proceedings is greatly lessened. We also state that, in light of the safeguards for ratepayer protection we are adopting as part of the new regulation, we will closely scrutinize future filings which place USWC earnings at issue. Although we cannot approve a rate case moratorium, it is our intent that the plan be given sufficient time and opportunity to work. Absent changed circumstances, the plan is intended to be self-correcting over the 5-year period.

just and reasonable terms).

Finally, and most importantly, we are convinced that there is little, if any, risk to ratepayers in the plan we approve here. Under traditional regulation, in a situation of utility overearnings ratepayers would see no benefit in the form of lower rates for, at a minimum, 18-24 months due to regulatory lag. The plan adopted here will result in a reduction of rates, if the Company overearns, on an annual basis. Moreover, Part 2 rates will be frozen, except for rate increases we approve or have approved (*i.e.,* SAFE and RFIP) under traditional procedures. Essentially, the calculation as to whether ratepayers are harmed under the new scheme involves this comparison: USWC's retention of all earnings for 18-24 months followed by fixed rate reductions for ratepayers versus USWC's retention of only a portion of excess earnings (no more than 65 percent at the margin) for the term of the plan with no fixed rate reductions.[25] When we consider that the Company will be required to file a rate case if earnings exceed a certain level, and 100 percent of earnings in excess of the cap will be "returned" to ratepayers, we conclude that customers, insofar as rates are concerned, will likely benefit from incentive regulation, and, in any event, will not be harmed.[26]

---

[25] "Fixed rate reductions" refers to rate decreases ordered pursuant to a rate case.

[26] A regulatory system which reduces the number of formal rate proceedings--proceedings which are extremely costly to all participants--will additionally benefit the Company and ratepayers by reducing expenses, many of which

COMMISSION-APPROVED PLAN

Having determined that the case for incentive regulation has been proven, we now discuss the components of an appropriate plan. At the outset, we note that the new scheme which is set forth, *infra*, should be in effect for a 5-year period beginning January 1, 1993. The plan is new and experimental. A lesser period of time may not provide enough experience to allow us to determine whether this change in regulation is actually beneficial to the ratepayers and the Company. We agree with USWC that change in corporate entities such as the Company (*e.g.,* cutting costs, motivating employees consistent with a new corporate culture which recognizes the threat of competition and the necessity of customer focus) is a slow process. Moreover, the safeguards adopted as part of the plan (*e.g.,* continued financial monitoring, cap on earnings, lack of a rate case moratorium) address concerns associated with a longer term for the new regulation. The commission shall conduct an evaluation of the plan approximately midway through its term. At the end of 1997, a hearing will be conducted on the form of earnings regulation to follow. With this in mind, the components of the approved AFOR follow.

SHARING MECHANISM

---

are recovered in rates.

Initially, we must decide the appropriate rate of return which will serve as the sharing threshold. None of the parties disputed that the proper starting point should be the presently authorized rate of return. However, the OCC and USWC take different positions regarding what the existing authorized ROE is. The OCC contends that authorized ROE is 12.5 percent, inasmuch as rates which were approved in the most recent USWC general rate case, Docket No. 90S-544T, were based upon that return. In response, the Company asserts that the commission's order in that proceeding expressly adopted 13.5 percent as the proper ROE. The Company is correct on this issue.

In Decision No. C91-497 (page 7), Docket No. 90S-544T, we specifically held, "It would be fair and reasonable to establish U S WEST's authorized rate of return on equity at 13.5 percent, as requested, and its return on rate base at 11.71 percent." We acknowledge that the stipulation, which was approved by the commission, between the parties in Docket No. 90S-544T called for the Company's rates to be set based upon a 12.5 percent ROE. This setting of rates based upon 12.5 percent ROE, even though approved ROE was 13.5 percent, was a concession made by the Company in the course of negotiations in the rate case. However, the same stipulation, in conjunction with our order approving it, specifically provided that authorized ROE would be 13.5 percent. No evidence has been presented in this case which would allow us to change our previous determination. Therefore, for purposes of the sharing mechanism adopted here, 13.5 percent ROE is determined to be the point at which sharing of earnings is to begin.

The OCC also suggested that $3.5 million be refunded to ratepayers as a "consumer dividend," regardless of the level of Company earnings. We reject this proposal. In the first place, such a refund would be illegal as retroactive ratemaking, especially since the Company has not assented to it. Second, assuming for the sake of discussion only that such a refund would be legal, the rationale for the proposal was not sufficiently supported in the record. The OCC's theory for the automatic refund is that $3.5 million represents "embedded efficiency" based upon an estimate made by Staff witness Mitchell in 90S-544T. Notably, Mr. Mitchell, who also testified in the present proceeding, did not himself suggest such a "consumer dividend." OCC witnesses themselves were not aware of the basis of Mr. Mitchell's calculation of embedded efficiencies. In short, the record does not support what would be, in effect, an adjustment to USWC rates.[27]

We do agree with those witnesses, such as Mr. Montgomery and Dr. Cornell, who supported a "reverse taper." This mechanism would afford ratepayers the largest percentage of the initial overearnings. As the Company achieves greater efficiencies and earnings, its proportionate share would increase. The initial

[27] Furthermore, the OCC's proposal to, in essence, decrease rates based upon one item, embedded efficiencies, strikes us as the type of piecemeal ratemaking which the OCC typically opposes.

overearnings are, of course, the most easily obtained. Giving ratepayers the greater share of the first overearnings will increase the customers' likelihood of benefitting from this plan. In addition, a reverse taper will motivate the Company to greater efficiency by increasing its reward for the higher rates of return, which are more difficult to obtain. Both outcomes are consistent with the purpose of incentive regulation.

In accordance with these findings, we approve the following sharing formula:

Range of Return on Equity	Sharing Percentages
Below 13.5%	100% Company
13.5 -- 14.5%	65% Ratepayers 35% Company
14.5 -- 15.5%	50% Ratepayers 50% Company
15.5 -- 16.5%	35% Ratepayers 65% Company
Above 16.5%	100% Ratepayers

As noted on the above table, sharing will begin when the Company's earnings reach 13.5 percent ROE. Earnings in excess of that level will be split between ratepayers and USWC according to the above-stated percentages. Earnings in excess of 16.5 percent ROE will be returned in their entirety to customers. In addition, since this level of profits would indicate that rates are unreasonably high, the Company will be required to file a rate case when ROE reaches 16.5 percent.

We find that earnings under the plan should be measured using ratemaking principles. That is, all commission-ordered and all accounting adjustments, except for *pro forma* adjustments, must be used. We expressly reject the Company's request that earnings be measured simply from unadjusted FR books. As all parties except for the Company contended, failure to use ratemaking principles in measuring earnings would constitute abandonment of our responsibility to regulate. In order to ensure ratepayers are treated fairly under the plan, and to ensure the Company does not retain windfall profits which are not due to increased efficiencies, all commission-ordered adjustments and ratemaking principles will be employed when measuring earnings. By June 1 of each year, USWC will file a report on earnings containing the book numbers from the previous year, together with accounting and commission-ordered adjustments. Staff will audit these numbers within 30 days of filing. If deemed satisfactory, these data will be used for purposes of determining sharing amounts between the Company and ratepayers.

The ratepayers' share of earnings in excess of the previously authorized rate will be "returned" to them by a prospective rate reduction in an amount sufficient to account for customers' share. This negative rider will be applied uniformly to all Part 2 and 3 services. At hearing, a dispute arose between the OCC and the interexchange carriers as to whether Part 3 customers would participate in sharing. We accept the positions of AT&T and MCI that, because <u>all</u> customers contribute to Company overearnings, <u>all</u> customers should participate in any adopted sharing mechanism as a matter of fairness. In particular, we hold that purchasers of switched access service also should benefit from sharing.[28]

---

[28] Since AT&T has committed to flow-through to customers all monies "returned" to it, with the caveat that it may request a modification of this flow-through commitment if future circumstances require, end-users will benefit even from these

RATES AND RATE PROCEEDINGS UNDER AFOR

Except for certain expense items which were listed above, USWC offered to freeze Part 2 rates for the duration of its proposal. The term "rate freeze" was somewhat misleading, since the number and scope of the original exceptions to the "freeze" were substantial (*e.g.,* commission-approved rate increases, changes in taxes, changes to comply with new accounting procedures promulgated by various agencies, changes in federal separations). We believe a so-called "rate freeze" for Part 2 services is an important component of the new regulatory system.

The essence of incentive regulation is to motivate the utility to achieve even greater efficiencies than those produced under traditional regulation. In order to accomplish this with USWC, the AFOR scheme must lessen the likelihood of rate proceedings, at least insofar as the proceedings concern the Company's earnings. Unless the Company's opportunity to recover new or increased expenses by the filing of rate requests is restricted, as compared to present regulation, an incentive plan would be largely illusory.[29] Therefore, increases to Part 2 rates (*e.g.,*

---

shared amounts. While AT&T has made no commitment as to how flow-through will occur, we assume <u>all</u> its customers will benefit.

[29] We recognize the same can be said about ratepayer-initiated proceedings to capture the effects of lowered expenses or increased revenues. Our legal inability to impose a rate case moratorium potentially reduces the effectiveness of any incentive regulatory scheme. However, as we explained, *supra*, we are convinced that

to recover new expenses) must be limited for the duration of the plan.

The Company substantially modified its position as to those expenses which it requested could be recovered, at least in part, from Part 2 rates as an exception to the rate freeze. USWC now proposes only two exceptions to the rate freeze: (1) increased costs and expenses associated with SAFE, RFIP, and similar programs purportedly involving extraordinary investment for the purpose of improving telephone service; and (2) expenses associated with accounting changes for post-retirement benefits ("PRB"). In both instances, recovery of expenses through increased Part 2 rates would be subject to approval by the commission.

The Company's position on the two exceptions is reasonable. We have previously found that the SAFE and RFIP programs are in the public interest, and the commission has approved recovery of those costs in Part 2 rates. It is not the purpose of the present proceeding to re-examine those prior decisions. Therefore, at least portions of the expenses associated with these two programs will continue to be recovered in Part 2 rates consistent with our previous rulings. Additionally, the second phase of RFIP is presently pending before us. It is not our intent, by adoption of

---

sharing of overearnings along with other safeguards adopted herein, as well as our stated intention to scrutinize the validity of any filings involving the level of USWC earnings during the duration of this plan, will substantially reduce the likelihood that ratepayers or their representatives will initiate rate cases which are detrimental to the intent of this plan.

incentive regulation, to discourage the Company from meeting its clear obligation to improve telephone service in the State.[30] Since this portion of the Company's offer contemplates submission to and approval by the commission before the costs of such programs could be recovered in rates, it should be adopted. It is in the public interest for the PUC to retain the flexibility to approve such programs and allow cost recovery, at least in part, from Part 2 services.

For similar reasons, we also accept USWC's suggestion with respect to PRB costs. The Company is proposing simply that it be allowed to request a rate increase in the future for new PRB expenses. We are retaining the discretion to disapprove the rate request. Moreover, there is some equity in allowing the Company a limited opportunity to request a rate increase as an exception to the Part 2 rate freeze, in view of our inability to absolutely preclude ratepayer-initiated rate cases. With the two exceptions just noted, we adopt a rate freeze for Part 2 services during the term of the plan.[31]

As for Part 3 services, USWC requested pricing flexibility, the authority to engage in promotional offerings, and the ability

---

[30] Whether programs such as RFIP II are truly extraordinary undertakings which necessitate extraordinary cost recovery mechanisms shall be determined in those specific cases.

[31] All parties should understand that we now take no position as to the manner in which the Company may request rate recovery for PRB or SAFE- and RFIP-type programs. For example, we do not decide here whether we will allow piecemeal rate recovery for these expenses (*i.e.*, a rate increase for single line items) or whether we will consider all Company expenses and revenues when, and if, the Company files for these expenses. Additionally, the extent to which these expenses will be recovered from Non-Part 2 services is left for the future.

to provide these services pursuant to contract in certain circumstances. We have already ruled, *supra*, that these issues must be left for the Costing and Pricing Docket, 92M-039T.

If, during the term of AFOR, any party files a rate case which places USWC's rates and earnings at issue, the commission may terminate this plan. The rates in effect pursuant to the plan will remain in effect until the case has been completed (*i.e.,* applications for reconsideration finally ruled upon). Sharing of excess earnings, if any, will continue as directed in this opinion until a final commission decision is issued.

Cost allocations between Parts 2, 3, and 4 offerings, as required by commission rules or orders, shall continue to be performed by the Company. While the decision in the pending Costing and Pricing Docket, Docket No. 92M-039T, may affect this directive, nothing in the present proceeding is intended to supersede any cost allocation requirement previously adopted.

QUALITY OF SERVICE

All parties agree that quality of service standards are essential for any incentive regulatory plan. Without such standards service quality could deteriorate as the Company cut costs in an attempt to increase earnings. While the parties all agreed that quality of service standards are a necessary part of any plan, there was little agreement as to the precise measures of service quality, or as to how service quality scores should affect sharing. We first address the specific measures for service quality.

Both Staff and the Company modified their original positions on quality of service measures by stipulating to the provisions in Exhibit 41. The list of the agreed upon service measures, their possible weightings, and performance objectives are contained in Exhibit A which is attached to the stipulation. (Since we largely accept Exhibit A as the quality of service measures in this decision, that document is attached to this order.) Exhibit A lists 14 items to be measured, 2 being subjective factors from the CSM. Those two items are given a total weighting of 20 percent.[32] All other standards listed are objective measures of maintenance (45 percent), provisioning (25 percent), and customer access (10 percent). Exhibit A explains all items.

Scoring pursuant to the stipulation would operate in the following manner: if the Company's performance on the specified measure is within the stated bands, the resulting score for that specific measure would be 0 percent. Superior performance outside the band would result in the assigned weighting being added to the final service quality score. Inferior performance outside the band would result in the assigned weighting being subtracted from the final score. For example, on the trunk blocking measure,

[32] Although Staff signed the stipulation, it did not agree to the use of CSM nor to a weighting of 20 percent for these two items.

blocking above 2.0 for 1993 would result in a 5 percent reduction to the final quality of service score; blocking below 1.0 would result in 5 percent being added to the final score; blocking between 1.0 and 2.0 would result in a 0 percent contribution to the service quality score. The result of the calculation of service quality in the proposal is a number between -100 and +100. This service quality score would affect the sharing of overearnings differently under the Company's and Staff's plans. The stipulation does not settle how each party would factor in the resulting quality-of-service score.

Staff and the Company agree that those measures listed on Exhibit A should be used in an AFOR plan, except for the two standards relating to the CSM. In the Company's view, the CSM factors should count for 20 percent of the total service quality score. Staff, on the other hand, still opposes use of CSM for reasons articulated by such witnesses as Mr. Berry. Essentially, Staff contends that CSM, as a survey of customer opinion, is a highly inappropriate measure. Staff does agree that the results of a customer survey should be used as one component of a quality of service plan. However, Staff supports use of market unit surveys if these can be improved to an acceptable level of statistical validity for Colorado-specific survey data. In the event the market unit surveys cannot be so improved, Staff recommends use of CSM for 1 year only, provided that it receives no more than a 10 percent weighting. Staff urges that, during the first year of AFOR, an acceptable alternative to CSM be developed along the lines suggested by witnesses Berry and Williams.

The OCC also criticized the CSM, and opposed Exhibit 41. In part, the OCC argues that the Company should be required to meet the minimum service quality standards set forth in existing rules before incentive regulation is implemented. Exhibit 41, according to the OCC, does not mandate compliance with current quality of service rules. Additionally, the OCC finds the stipulation between Staff and the Company unacceptable, inasmuch as it does not include measures of held regrades, out-of-service reports over 24-hours, or measures relating to customer satisfaction with billing. The OCC recommends cooperative development of service quality measures during the first year of AFOR, for implementation during all subsequent years. During the first year, the Company would be required to comply with existing rules and to realize significant, but unspecified, improvements in two interim measures, trouble reports per access line and number of service orders held over 1 month.

AT&T also criticized the service quality measures stipulated to in Exhibit 41 and its attachment. As noted above, AT&T is primarily concerned with quality of service standards as they relate to carrier access. In its closing statement of position, AT&T suggested five measurements related to access service for inclusion into service quality standards. Two of these, call blockage and customer trouble reports, were included in the stipulation. However, AT&T objects to Exhibit 41 to the extent installation commitments, on-time installations, and restoration of failed circuits would not be measured. In an attachment to witness Zahn's direct testimony (Exhibit 23), AT&T recommended specific standards for these three items. For example, Mr. Zahn suggested that the standard for installation commitments be as follows: 97 percent of orders for circuits be assigned an installation date within 7 days of receipt of order; for on-time installations, 98 percent of orders be installed on time; and for restoration of failed circuits, 98 percent of such circuits be restored within 24 hours. Besides the non-inclusion of measurement standards for these three items, AT&T, as we understand its present position, does not object to Exhibit 41 criteria.[33]

We find that the service quality standards listed on Exhibit A of Exhibit 41 are reasonable. Generally, those standards are objective, measurable, and indicative of the quality of service provided by the Company. However, we accept the criteria listed on Exhibit A of Exhibit 41 only as a good starting point for the service quality component of AFOR. While we agree with Staff that CSM is an inappropriate measure of consumer opinion regarding quality of service, we also agree with Staff's position that consumer opinion is an important element in

[33] The other parties' positions on Exhibit 41 are essentially encompassed in that of Staff or in the criticisms offered by AT&T and the OCC.

measuring quality of service. Because an acceptable customer survey is not now in existence, and may not be in existence in the first year of AFOR, we approve the use of the CSM for the first year, solely as an interim device, with a weighting of 10 percent. In addition, we accept Staff's recommendation that the other 10 percent weighting of CSM on Exhibit A be allocated to the three maintenance sub-categories in proportion to the weightings shown in that exhibit. The Company, Staff, and other interested parties shall jointly develop and offer for commission approval by January 1, 1994 an acceptable consumer survey for use in subsequent years of AFOR.

Some of the criticisms leveled at the stipulation have some validity. Specifically, AT&T's objections regarding the absence of certain measures related to carrier access is noted and should be addressed. Switched access is an important, mostly non-competitive service provided by the Company, and the quality of this service should be measured in any fine-tuned AFOR plan. Similarly, the OCC's and other parties' concern that USWC be required to meet specified minimum levels of service before sharing in overearnings is shared by the commission. However, we feel that the criticisms are not sufficient cause for delaying implementation of incentive regulation. We again note that the standards contained in the stipulation are <u>reasonable</u> and effective measures of quality of service. This does not mean we should not work to improve upon the measures temporarily adopted here. Staff and the Company, along with other interested parties, shall jointly develop for our review and approval, by January 1, 1994, modifications to Exhibit A which address the concerns of Staff, the OCC, and AT&T.

We modify the stipulation between the Company and Staff in one respect. The performance bands specified in Exhibit A, along with the assigned weightings and the method of calculating the quality-of-service score, introduce an unacceptable discontinuity into the calculation of a final score. For example, on trunk blocking a minimal improvement in performance from slightly more than 1.0 to slightly less than 1.0 would improve the final service quality score by the entire 5 percent assigned weighting. In order to avoid this discontinuity, we direct that changes in performance within the specific bands on Exhibit A shall result in proportionate changes to the assigned weightings added or subtracted to the final score. For example, a performance of 1.0 or better on trunk blocking will increase the quality-of-service score by 5 percent; a performance of 1.1 will increase the score by 4 percent; etc. A score of 2.0 or worse on trunk blocking will result in a reduction to the final score of 5 percent.[34]

QUALITY OF SERVICE SCORES AND SHARING

[34] For purposes of this illustration, we used the 5 percent weight assigned to trunk blocking on Exhibit A.

The above discussion establishes most of the service quality measures to be used in AFOR. However, once the quality-of-service score is calculated for a given year, the result must be factored into the sharing mechanism. This will be accomplished in the manner described here.

The Company will be allowed to retain all earnings up to a 13.5 percent ROE; ratepayers will receive all earnings in excess of 16.5 percent ROE. For other overearnings between these two returns, it is appropriate to provide the Company financial incentives which will enable it to retain a greater share for better service quality, and a lesser share for poorer service quality. This will protect against degradation of service and will motivate the Company to improve quality of service over time. We intend to provide these incentives in a two-fold process.

The net score calculated from the measures and the methodology discussed in the preceding section, will be used to adjust the band limits set forth on the table on page 41, except for 13.5 percent and 16.5 percent ROEs. If the net score is positive, indicating good performance on average, the band limits will be lowered proportionately to reward the Company for this positive performance. This lowering of the band limits will allow USWC to reach more favorable sharing apportionments more quickly. For example, if the net score is +30 percent, the figures 14.5 percent and 15.5 percent in the ROE column in the above-referenced table will be adjusted to 14.2 percent and 15.2 percent. This will enable the Company to retain 50 percent of earnings between 14.2 percent and 15.2 percent ROE, and 65 percent of earnings between 15.2 percent and 16.5 percent ROE. On the other hand, if the net service quality score is negative, indicating poor performance, the band limits will be raised proportionately, and the Company will reach the more favorable sharing apportionments more slowly. A net score of -25 percent will cause the band limits on the sharing table to be raised--14.5 percent would be adjusted to 14.75 percent ROE, and 15.5 percent adjusted to 15.75 percent ROE. We find that adjustment of the sharing bands, as just described, is preferable to attempting to adjust sharing percentages, inasmuch as it is unclear as to what would constitute appropriate magnitudes of adjustment in the latter approach.

Staff, in particular, argued that individual measurement scores, not merely the net quality-of-service score, are important. According to Staff (*e.g.,* Wendling and Mitchell testimony), each of the individual measures is important in its own right, and net or aggregated scores may mask significant service problems shown by specific measures. We find this testimony to be credible and important. Consequently, negative scores on the individual quality-of-service standards will affect sharing in the following manner: all individual negative scores will be added to 13.5 percent to obtain an adjusted ROE, and all earnings between 13.5 percent ROE and the adjusted ROE will be returned to ratepayers through the prospective rate reduction. Any remaining earnings will be shared in accordance with the previously set thresholds. For example, if the Company scores -10 percent on one of the service quality standards (assuming no other negative scores), all earnings between 13.5 and 13.6 percent ROE will be returned to customers. Earnings between 13.6 and 14.5 percent ROE will be split 65 percent/35 percent, between 14.5 and 15.5 percent ROE on a 50 percent/50 percent basis (assuming no adjustment to 14.5 and 15.5 percent due to a net score of zero), etc.

We find that this two-step process adequately addresses concerns with utilizing only net scores. In addition, we find that this general approach to accounting for service quality scores gives appropriate incentives to the Company to maintain and improve quality of service.

MODIFICATIONS TO CUSTOMER COMPLAINT PROCESS

Staff also proposed a number of other changes to the consumer complaint process as a means of further improving service quality. We accept two of these. In his testimony, Mr. Cunningham proposed an 800 "hotline" concept and $10 rebates to customers when USWC misses scheduled service dates. The hotline proposal would provide customers having unresolved complaints and problems with a means of contacting Company representatives, other than the front-line customer service representatives. Presently, the commission External Affairs Staff utilize a similar mechanism through the office of the Company's Colorado Vice-President. When customers are unable to resolve problems under normal complaint procedures, experienced customer service personnel answering the hotline are available. Essentially, this concept calls for intervention of employees at a higher level in the Company (*e.g.,* an ombudsman) when routine complaint procedures fail.

Staff's suggestion is worthwhile, and should be implemented as one means of improving quality of service under incentive regulation. The Company is directed to establish a statewide hotline consisting of WATS lines into the office of the Vice-President, or other office designated by USWC, with the lines staffed by experienced customer service representatives. In order to inform customers of this service, the hotline numbers shall be publicized by the Company in its directories and on each billing statement. It is acceptable for the public notices to state that the hotline number is not meant for routine service order or repair calls.

As for the $10 rebates for missed service calls, we note that the Company did not oppose this proposal. We here direct that, as part of implementation of AFOR, the Company shall establish procedures for rebating $10 to customers for missed service dates (*i.e.,* when an appointment for a premise visit associated with installation of new service or with a regrade of service is missed). This rebate will also apply to installation work in the central office when no premise visit is required.

We reject other specific suggestions made by Staff and other parties. These other recommendations are either too punitive and unnecessary in light of the service quality provisions adopted here (*e.g.,* higher rebates for missed service appointments and held orders), or are likely unlawful (*e.g.,* reallocating the burden of proof in complaint proceedings from the complainant to the Company).

ELEMENTS REJECTED

In our approved plan, we have rejected a number of specific components of incentive regulation which various parties proposed. Some of these have already been addressed in the above discussion. In particular, we have ruled that we will not grant pricing or other regulatory flexibility for Part 3 services in this docket. See discussion on page 30. These issues will be taken up in the Costing and Pricing proceeding, Docket No. 92M-039T. Similarly, we have held that we will not now change any cost allocation requirements presently imposed on the Company. Cost allocation between specific services and between Parts 2, 3, and 4 offerings in the aggregate is more closely related to issues arising in 92M-039T. Moreover, since some of the cost allocation mandates are now set forth in existing rules, changes to these requirements must be effected through rulemaking. Therefore, we deny the Company's request to modify cost allocation procedures or requirements in the present docket.

The Company's original application for incentive regulation also suggested an automatic pass-through mechanism for certain expenses. We understand that this request was largely abandoned at the hearing. *See* discussion on page 9 regarding USWC's Statement of Modifications to Application. Now the Company no longer requests an automatic pass-through, except for SAFE- and RFIP-type costs approved by the commission. We have accepted USWC's modified position, page 44.

Various parties (Staff, DOD, and CML/CCTA) proposed a separate efficiency measure as one element of incentive regulation. DOD and CML/CCTA suggested total factor productivity; Staff suggested cost/access line. In these formulations of incentive regulation, the Company's right to retain some portion of over-earnings would be affected by its performance as measured by cost/access line or TFP. We reject such proposals. In our view, such separate efficiency standards are unnecessary. Our approved plan incorporates a reverse taper which provides the Company with significant motivation to achieve higher levels of efficiency. The major rationale for incorporating a separate efficiency standard was to ensure that the Company was given sufficiently powerful incentives to become more and more efficient. Substantial sharing by the Company of the early and most easily achievable overearnings might lead to complacency. The separate efficiency measures are designed to motivate the Company to higher levels of productivity. We are satisfied that the reverse taper accomplishes the essential purpose of a separate efficiency standard.

Furthermore, the specific measures suggested by the parties are problematic for various reasons. Staff's cost-per-access-line measure is susceptible to change for reasons unrelated to efficiency. Specifically, cost per access line is subject to change as a result of the mix of services provided, and not only as a result of increased productivity. In addition, this standard could discourage the Company from investing in beneficial projects in an attempt to achieve a better rating under Staff's proposal. We have some concern that an adopted AFOR plan maintain incentives for investment in the network. Adoption of any standard which might discourage investment is unacceptable. In fact, any such unintended result would be sufficient cause to terminate the plan and initiate investigatory proceedings.

As for TFP, experience from other jurisdictions (*i.e.,* the FCC price cap docket, CC Docket No. 87-313) reveals that it is difficult to measure. Even Staff, one of the proponents of a separate efficiency standard, agreed that TFP is contentious, difficult to quantify, and prone to error. In light of the marginal utility of such a standard under our approved plan, and in light of the administrative burden of implementing the proposals, we reject all separate efficiency measures in AFOR.

The Company also suggested an energy conservation incentive as part of its application. This component would give USWC additional monies to the extent its energy charges in future years are lower than its 1989 bill. We disapprove of this element of the plan. As numerous parties noted, it would be difficult to determine whether energy savings were due to conservation efforts or other unrelated reasons (*e.g.,* a reduction in office space). Most importantly, we see no reason to distinguish energy conservation by the Company from other efficiencies under incentive regulation. In separate proceedings, we are pursuing demand side management programs. We do not disagree with the statement in the concurrence regarding the Company's leadership role and the importance of its actions in this area. However, we have learned from the other dockets to which Commissioner Nakarado refers, that the Company will profit greatly from meaningful participation in energy efficiency programs. The rational incentives to participate in these programs are significant lowering of expenses and thus, in connection with this docket, a relatively simple way to help reach the point of earnings above the authorized rate of return. The Company has the opportunity to participate in those initiatives. No reason exists to adopt a separate energy conservation incentive as part of this case.

Next, the Company proposed an extraordinary investment component and a baseline investment commitment as part of its incentive regulatory scheme. We reject both suggestions. With respect to the extraordinary investment element, USWC proposed that the ratepayers' share of overearnings be retained by the Company and invested in projects, subject to approval by the commission, which would not be funded under the Company's normal capital budgeting process.[35] All parties opposed this component of the application. Even the Company's support for this proposal was only moderate.

We initially note that, given our decision to return ratepayers' share of overearnings by prospective rate reductions, no monies will be available for an extraordinary investment fund. So there is no doubt in the matter, we expressly disapprove the extraordinary investment concept. The extraordinary investment proposal is inappropriate inasmuch as it could result in uneconomic or unnecessary investment. In fact, the Company itself characterized the projects which might be financed with the fund as those which would not otherwise be financed by shareholders, in many instances, because of anticipated low returns. We recognize that some programs such as SAFE and RFIP should be undertaken in spite of expected low returns. However, our decision here allows

[35] Supposedly, ratepayers would share in overearnings, even though their share was retained by the Company, because the costs of the selected projects would not become part of rate base and accounting adjustments would be made to reflect that financing for the projects was ratepayer-provided capital.

the Company to propose specific projects and specific methods of financing as exceptions to the rate freeze. We do not believe that an extraordinary investment component is an essential part of AFOR.

As for the baseline investment commitment, the Company proposed to guarantee certain levels of investment while AFOR was in effect. See discussion, *supra*. According to the Company, the purpose of this commitment was to assure the commission that necessary investment in facilities would continue even as cost-cutting measures were taken under incentive regulation. The Company's offer does not give us the assurances which were the rationale for the proposal. For example, Staff pointed out that during the years 1988-90 and projected 1991, USWC's commitment would have resulted in $307.4 million less investment than actually occurred in 1988-90 and was projected to occur in 1991. If establishing a minimum level of investment induces USWC to consider the minimum to be sufficient, desirable investment may not be undertaken. We also find that it is improper for us to require a predetermined level of investment, all or most of which would be placed into rate base, without regard to need. As MCI noted, this mechanism could lead to uneconomic investment which would be recovered from regulated rates.

Present law and regulation require the Company to make those investments necessary to provide adequate telephone service. The Company, even under incentive regulation, is expected to comply with these mandates, and failure to do so will result in heightened scrutiny by the commission. In light of those requirements, we reject the baseline investment commitment as unnecessary.

CONCLUSION

In this decision, we have determined that incentive regulation for the Company is in the public interest, and that the plan we adopt here is a reasonable and moderate change to traditional methods of regulating USWC earnings. It is necessary to address one final issue.

In his direct testimony (Exhibit 6), Mr. Wendling recommended that the commission adopt a "telecommunications vision." By this, Mr. Wendling meant that we should determine, in part: (1) what telephone services are considered basic or necessary for the State; (2) what regulatory pricing scheme will apply to these services; (3) what technology will be used to provide these services; and (4) the timetable for deployment of necessary technology specific to the various geographic/demographic characteristics of the State. Mr. Wendling recommended that we adopt goals to implement this telecommunications vision through a collaborative process involving "the broadest spectrum of possible constituencies" (page 13, Exhibit 6).[36] As most related to the present case, Mr.

[36] An illustration of a telecommunications goal (or vision) involving

Wendling finally concluded that progress towards meeting these adopted goals should be part of our incentive regulatory plan.

Defining what the telecommunications vision for the State should be is beyond the scope of the present proceeding.[37] However, we agree that we must now address Mr. Wendling's suggestions, at least in one respect. Mr. Wendling's testimony reminds us that the commission must be vigilant against the possibility that an incentive regulatory scheme may discourage the Company from undertaking beneficial investment to improve the network. Insofar as the Company will have incentives to cut costs and increase earnings under AFOR, implementation of a future-defined telecommunications vision could be hampered by incentive regulation, if proper safeguards are not included. We believe the adopted plan, in conjunction with our continuing regulatory authority over the Company, contains sufficient safeguards. We assure all parties and the public that the commission will continue to be mindful of the need for adequate telecommunications services, especially under incentive regulation.

THEREFORE THE COMMISSION ORDERS THAT:

---

basic service was given by Mr. Wendling. This included universal, one-party service with transmission quality necessary to transport low-speed data, facsimile, and voice; touchtone; digital or stored program control central offices; digital interoffice facilities; a local calling area encompassing the user's community of interest; and access to the network through open network architecture.

[37] We note that we are scheduled to take up some of the issues referenced in Mr. Wendling's testimony in other dockets. For example, the second phase of the rural telephone facilities improvement program is set for hearing in October of this year. We have also initiated rulemaking regarding the definition of basic local service.

1. U S WEST Communications, Inc.'s application for an alternative form of regulation as modified in this Decision is hereby approved consistent with the above discussion.

2. The 20-day time period provided for by § 40-6-114(1), C.R.S., to file an application for rehearing, reargument, or reconsideration begins on the first day after the mailing or serving of this Decision and Order.

This Order is effective on its Mailed Date.

ADOPTED IN OPEN MEETING May 26, 1992.

THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF COLORADO

____

____

Commissioners

COMMISSIONER GARY L. NAKARADO
CONCURRING IN PART AND
DISSENTING IN PART--
OPINION TO
FOLLOW.