D.P.U. 94-50

Petition of New England Telephone and Telegraph Company d/b/a NYNEX for an Alternative Regulatory Plan for the Company's Massachusetts intrastate telecommunications services.

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AFUDC	allowance for funds used during construction
AIN	Advanced Intelligent Network
Attorney General	Attorney General of the Commonwealth
AREI	Actual Rate Element Index
ARL	average remaining life
API	Actual Price Index
AT&T	AT&T Communications of New England, Inc.
Bellcore	Bell Communications Research
BOC	Bell Operating Company
BROR	Benchmark Rate of Return
BROR	base rate of return
CAPM	capital asset pricing model
COSS	cost of service study
Court	Massachusetts Supreme Judicial Court
CPE	customer premises equipment
CPI	Consumer Price Index
CSPI	Competitive Services Price Index
CWC	cash working capital
D.C. Commission	District of Columbia Public Service Commission
DCF	discounted cash flow
Department	Department of Public Utilities

ETI	Economics and Technology, Inc.
FAS	Financial Accounting Standards
FAS 87	Financial Accounting Standard 87
FAS 106	Financial Accounting Standard 106
FCC	Federal Communication Commission
FEA	Department of Defense and all other Federal Executive Agencies
GAAP	generally accepted accounting principle
GDP-PI	Gross Domestic Product-Price Index
GNPIPD	gross national product implicit price deflator
IBES	Institutional Brokers Estimate System
ISDN	integrated services digital network
IXCs	interexchange carriers
LATA	local access and transport area
LECs	local exchange carriers
LEC Parent	Local Exchange Company parent
MAPI	Maximum Annual Price Increase
MCI	MCI Telecommunications Corporation
MCS	marginal cost study
MFJ	Modified Final Judgment
NARUC	National Association of Regulatory Utility Commissioners
NCTE	Network Channel Terminating Equipment
NECTA	New England Cable Television Association, Inc.
NELF	New England Legal Foundation

NEPCC	New England Public Communications Council, Inc.
New York Commission	New York Public Service Commission
NGA	NYNEX Government Affairs
NIRC	NYNEX Information Resources Company
NP	NYNEX Properties
NYNEX Company NET	New England Telephone and Telegraph Company d/b/a NYNEX
NYPSC	New York Public Service Commission
NYT	New York Telephone
ONA	Open Network Architecture
PAYG	pay-as-you-go
PBOP	post-retirement benefits other than pensions
PCI	Price Cap Index
Plan	Alternative Regulatory Plan
PRE	Process Re-engineering Initiative
PRI	Price Regulation Index
R&D	research and development
RBOCS	Regional Bell Operating Companies
REI	Rate Element Index
RHCs	regional holding companies
ROI	return on investment
ROR	rate-of-return
RTU	Right to Use

S&P	Standard and Poor's
S&T	NYNEX Science and Technology
SBUs	Strategic Business Units
SEC	Securities and Exchange Commission
SQI	Service Quality Index
TFP	total factor productivity
TRG	Telesector Resources Group
TSLRIC	total service long-run incremental cost
USTA	United States Telephone Association
VEBA	Voluntary Employees' Benefit Association Trusts
Vermont Board	Vermont Public Service Board
VMS	Voice Messaging Service
VOD	video on demand

I. INTRODUCTION

On April 14, 1994, New England Telephone and Telegraph Company d/b/a NYNEX [1] filed with the Department of Public Utilities ("Department") an Alternative Regulatory Plan ("Plan") for its Massachusetts intrastate operations. [2, 3] The Plan proposes an alternative form of regulation for NYNEX to replace

[1] For purposes of this Order, the Department refers to New England Telephone and Telegraph Company's ("NET's") Massachusetts operations as "NYNEX" or "Company." We use the term "NYNEX Corporation" to refer to NET's parent, and we use the term "NYNEX-New England" to refer to the five-state operations of NET.

[2] The Company initially filed the Plan as revisions to its tariff, M.D.P.U. Mass. No. 10, for effect May 14, 1994. The Department initially suspended the Company's filing for investigation until November 14, 1994. The Department subsequently found that the filing was neither a proper tariff filing, nor a request for a general increase in rates. See Section II.A., infra, for a discussion of the Department's Interlocutory Orders. Also included with the Company's Plan was a Motion to Defer the filing of the Company's 1994 transitional rate design pending the outcome in the instant proceeding. The Department granted the Motion to Defer in its June 14, 1994 Interlocutory Order, discussed in Section II.A.2, infra. The issue of whether to continue the transitional rate-restructuring process following issuance of this Order is addressed in Section V.B, infra.

[3] The Company filed a Motion to Amend its Plan on July 20, 1994. The Hearing Officers granted the Motion to Amend on August 2, 1994. The amendment inserted a paragraph into the Plan to clarify that the Company did not intend its Plan to limit competitors in their ability to seek interconnection arrangements, to petition the Department concerning such arrangements, or to assert claims that any term, condition, or rate relating to arrangements proposed by the Company would have an unreasonable, material adverse impact on competition (Motion to Amend at 1-2). The amendment is included in the evidentiary record as Exhibit NYNEX-5.

the Department's existing rate-of-return ("ROR") regulation. Instead of continuing to regulate the Company's expenses, revenues, and earnings, the Company proposed that the Department regulate its prices, in accordance with a "price cap" form of alternative regulation. In general, the "price cap" mechanism would allow the Company to change prices each year based on an index that accounts for inflation, a pre-determined productivity offset, and exogenous cost changes. The matter was docketed as D.P.U. 94-50.

Pursuant to notice duly issued, four public hearings were held on May 25, May 26, June 1, and June 2, 1994, in Plymouth, Boston, Worcester, and Pittsfield, respectively, in order to afford interested persons an opportunity to comment on the Company's Plan. Thirty days of evidentiary hearings were held at the Department's offices between July 11 and November 30, 1994. Pursuant to G.L. c. 12, § 11E, the Attorney General of the Commonwealth ("Attorney General") filed a notice of intervention in the proceeding. In addition, AT&T Communications of New England, Inc. ("AT&T"); MCI Telecommunications Corporation ("MCI"); the New England Cable Television Association, Inc. ("NECTA"); the Department of Defense and all other Federal Executive Agencies ("FEA"); the New England Public Communications Council, Inc. ("NEPCC"); MFS Communications Company, Inc.; Teleport Communications-Boston; Sprint Communications Company, L.P.; Southwestern Bell Mobile Systems, Inc. d/b/a Cellular One; RCI Long Distance New England d/b/a Long Distance North; ACC Corporation; the Commonwealth of Massachusetts Office of Management Information Systems; the Commonwealth of Massachusetts Executive Office of Economic Affairs; Representative Daniel E. Bosley; and Representative Christopher J. Hodgkins were granted intervenor status in the proceeding. [4] Boston Gas Company; Cambridge Electric Light Company, and Commonwealth Gas Company; the New England Legal Foundation ("NELF"); the Board of Hampshire County Commissioners; George C. Jordan, III; Mitchell Ziegler; and Mark Brown were granted limited participant status.

In support of its filing, the Company presented the testimony of Dr. William E. Taylor, senior vice president, National Economics Research Associates, Inc., who testified regarding price cap regulation and the proposed price cap formula; Dr. Laurits R. Christensen, president of Christensen Associates, who testified regarding productivity and input prices; Thomas W. Caldwell, managing director of marketing, who testified regarding the proposed price rules and tariff issues; James J. Lehane, director of public affairs for Massachusetts,

[4] The InterExchange Access Coalition ("IAC") and Locals 2222 and 2322, International Brotherhood of Electrical Workers ("IBEW") were also granted intervenor status. On July 22, 1994, the Hearing Officers granted IAC's motion to withdraw from the proceeding. On September 16, 1994, the Hearing Officers granted IBEW's motion to withdraw from the proceeding.

who testified regarding the proposed service quality index; John F. Killian, vice president for Massachusetts, who testified regarding the regulatory framework and investment commitments proposed by the Company; Edward J. McQuaid, managing director of finance for Massachusetts, who testified regarding the Company's level of earnings; and John H. Cogswell, a financial consultant, who testified regarding the reasonableness of the Company's currently authorized rate of return.

The Attorney General sponsored the testimony of Dr. Lee L. Selwyn, president, Economics and Technology, Inc. ("ETI"), who testified regarding alternative regulation for NYNEX, including the Attorney General's specific proposal for NYNEX; Dr. David J. Roddy, vice president and senior economist, ETI, who testified regarding the appropriate productivity or "X" factor; and Timothy Newhard, financial analyst, Office of Attorney General, Regulated Industries Division, who testified regarding the cost of equity for NYNEX. AT&T sponsored the testimony of Marc Rosen, government affairs vice-president for AT&T, who testified regarding regulation and competition in intraLATA telecommunications exchange markets; Dr. John W. Mayo, an economist, who provided an economic assessment of the Plan; Kevin Curran, AT&T division manager, consumer communications services, who testified regarding the impact NYNEX's proposed Plan would have on other carriers' ability to compete in the Massachusetts intraLATA market; and Dr. Brenda J. Kahn, staff manager, access management, network services, for AT&T, who recommended modifications to switched access rates and competitive safeguards for the Plan. MCI sponsored the testimony of Don A. Laub, manager, MCI state regulatory and governmental affairs department. FEA sponsored the testimony of Harry Gildea, a consultant with Snavely, King & Associates, and Mark Langsam, chief of the economics branch of the information resources and management service of the General Services Administration.

The evidentiary record consists of 1,356 exhibits. NYNEX entered 50 exhibits, the Attorney General entered 815 exhibits, AT&T entered 149 exhibits, MCI entered 19 exhibits, NECTA entered 245 exhibits, FEA entered three exhibits, and the Department entered 75 exhibits into the record. The record also includes the Company's responses to 159 record requests: 106 posed by the Attorney General, five posed by the IBEW, 30 posed by NECTA, five posed by AT&T, six posed by FEA, and seven posed by the Department; and the Attorney General's response to one record request posed by the Company. In addition, pursuant to 220 C.M.R. § 1.10(3), the following items were incorporated by reference into the evidentiary record: the Company's 1993 Annual Report to the Department; New England Telephone and Telegraph Company, Docket Nos. 5700/5702 (Vt. Pub. Serv. Bd. 1994); Illinois Bell Telephone Company, 92-0448/93-0239 Consol. (Ill.

Commerce Comm'n 1994); Affidavit of Dr. William E. Taylor (September 23, 1994); [5] and the Company's tariff filings and new service offerings approved by the Department after the filing of the instant petition (Tr. 15, at 41; Tr. 21, at 71; Tr. 23, at 9; Tr. 24, at 4; see, infra, n.24). [6]

Initial briefs were filed by NYNEX, the Attorney General, AT&T, MCI, NECTA, FEA, and NEPCC. [7] Reply briefs were filed by NYNEX, the Attorney General, AT&T, MCI, NECTA, FEA, NELF, and Mr. Ziegler.

II. PROCEDURAL HISTORY

[5] Dr. Taylor's affidavit was subsequently marked as Exh. NYNEX-40.

[6] On March 30, 1995, and April 11, 1995, respectively, the Attorney General and NECTA filed with the Department motions, pursuant to 220 C.M.R. § 1.10(2), for the Department to take official notice of (1) the Federal Communications Commission's ("FCC's") notice of decision in its price cap performance review (CC Docket No. 94-1), issued that same day, and (2) the FCC's Responsible Accounting Officer Letter 25, issued on April 3, 1995. On April 28, 1995, the Attorney General filed a motion for the Department to take official notice of the Maine Public Utilities Commission Hearing Examiner's Report in Docket No. 94-13. In addition, on May 3, 1995, the Attorney General filed a motion for the Department to take official notice of Appendix F of the FCC's decision in CC Docket No. 94-1. Given that these requests relate to evidentiary matters, we deny the motions on the grounds that the evidentiary record in this case closed on November 30, 1994, and the intervenors failed to move to reopen the record.

[7] On November 18, 1994, the Department issued suggested briefing questions. The following parties included responses to the briefing questions in their briefs: NYNEX, the Attorney General, AT&T, and MCI.

The Department has issued several Interlocutory Orders during the course of this proceeding. In addition, four Motions pending at the issuance of this Order are addressed in Section II.B, infra.

A. Interlocutory Orders

1. May 24, 1994 Interlocutory Order

On April 28, 1994, the Attorney General filed a Motion to Dismiss Petition or to Require Additional Filings ("Motion"). The Attorney General requested that the Department (1) find that the Company's filing was not properly a tariff filing under the Department's standards for tariff filings; (2) find that the Company failed to establish that its current rates are the appropriate starting rates for implementation of the Company's Plan; and (3) conduct the proceeding as a two-phase investigation -- a full rate case followed by an investigation into a proposal for alternative regulation (Motion at 7-9).

On May 24, 1994, the Department issued an Interlocutory Order on the Attorney General's Motion. NYNEX, D.P.U. 94-50 (May 24, 1994 Interlocutory Order) ("May 24, 1994 Interlocutory Order"). The Department found that the Company's filing was not a proper tariff filing and, therefore, vacated its April 20, 1994 Order of Suspension. May 24, 1994 Interlocutory Order at 14 & n.12, 16. The Department determined that it would treat the Company's filing as a petition for the implementation of its

Plan.[8] Id. at 14. In addition, the Department denied the Attorney General's request that the investigation be conducted in two phases. Id. at 15. The Department also determined that it would address the Attorney General's request regarding the appropriateness of the Company's current rates as the starting point for alternative regulation in conjunction with then pending motions on the scope of the proceeding. Id. The Department addressed this request of the Attorney General in its June 14, 1994 Interlocutory Order, discussed in Section II.A.2, infra.

2. June 14, 1994 Interlocutory Order

In addition to the Attorney General's Motion, other parties filed procedural motions or pleadings regarding dismissal, consolidation, expansion, and limitation of the scope of the proceeding. On May 9, 1994, MCI filed a Motion to Consolidate this case with D.P.U. 90-206/91-66, the Department's investigation into collocation and interconnection issues.[9] On

[8] The Department determined that the filing was not a request for a general increase in rates and denied the Attorney General's Motion based on his argument that the filing constituted a general increase in rates under G.L. c. 159, § 20. May 24, 1994 Interlocutory Order at 15. The Department concluded that it need not decide whether annual filings under the Plan would constitute a general increase in rates for purposes of ruling on the Attorney General's Motion. Id.

[9] Interconnection allows telecommunications providers to connect their networks directly into a local exchange company's ("LEC's") central office switching offices and local distribution network, and enables them to provide

(continued...)

May 11, 1994, NECTA filed a Motion to Dismiss ("NECTA's Motion to Dismiss"). On May 20, 1994, pursuant to a deadline established by the Hearing Officer, NYNEX, MCI, AT&T, the Attorney General, and NECTA filed Motions on Scope. Finally, with its petition for alternative regulation, NYNEX had filed a Motion to Defer the filing of its 1994 transitional rate design pending the Department's determination on the Company's Plan.[10]

On June 14, 1994, the Department issued its Interlocutory Order on Motion to Dismiss of NECTA; Motions to Consolidate of MCI, AT&T; Motions on Scope of NYNEX, AT&T, the Attorney General

[9] (...continued) alternative access to the LEC's central offices. Collocation arrangements allow network service providers to own and maintain fiber-optic cable and electronic equipment that is physically located in the LEC's central office.

[10] In D.P.U. 89-300, the Department conducted an examination of NYNEX's rate structure, representing the third phase in a multi-year investigation of NYNEX's rates. New England Telephone and Telegraph Company ("NET"), D.P.U. 89-300 (1990). In its Order, the Department directed NYNEX to make a series of revenue-neutral transitional filings that would move rates to cost-based levels, in accordance with target rates set in that proceeding. Id. In D.P.U. 89-300, D.P.U. 91-30, D.P.U. 92-100, and D.P.U. 93-125, the Department approved specific rate changes in this transitional rate restructuring process that represented the first through the fourth steps, respectively, in the direction of target rates and a target rate structure. See Id.; NET, D.P.U. 91-30 (1991); NET, D.P.U. 92-100 (1992); NET, D.P.U. 93-125 (1994). In D.P.U. 93-125, the Department reiterated its commitment to the timetable established in D.P.U. 92-100 for completion of the transitional process in two additional filings, and, thus, required the Company to make annual filings in 1994 and 1995, in order to complete the movement of rates to target cost-based levels. D.P.U. 93-125, at 77.

and NECTA; and Motion of NYNEX to Defer Transitional Filing. NYNEX, D.P.U. 94-50 (June 14, 1994 Interlocutory Order) ("June 14, 1994 Interlocutory Order"). With regard to NECTA's Motion to Dismiss on the ground that the filing was unlawful as a general increase in rates, the Department found the motion moot because of its ruling in the May 24, 1994 Interlocutory Order that the Company's filing was not a tariff filing and did not constitute a general increase in rates. June 14, 1994 Interlocutory Order at 11. The Department deferred ruling on NECTA's second ground for dismissal, which raised the question of whether the Department had authority under existing statutes to review and approve NYNEX's Plan. Id. at 12.[11]

With respect to the motions on scope, the Department summarized the parties' pleadings as requesting that the scope of the proceeding be expanded to include four subjects: "(1) a comprehensive review of telecommunications regulation in Massachusetts; (2) other forms of alternative regulation; (3) market structure; and (4) a full rate case." Id. at 19. The Department declined to include a generic telecommunications policy investigation as part of the proceeding. Id. at 20. The Department granted NYNEX's Motion on Scope and denied the

[11] The Department issued a subsequent Interlocutory Order on NECTA's second ground for dismissal on February 2, 1995. That Interlocutory Order is discussed in Section II.A.8, infra.

parties' motions on scope. Id. at 23. The Department concluded that the proceeding would encompass an investigation of NYNEX's petition for approval of its Plan, not a generic investigation into other forms of alternative regulation for NYNEX or other regulated utilities. Id. at 20. The Department provided that parties could propose modifications to the specific terms of NYNEX's Plan or advocate rejection of the Plan and retention of ROR regulation. Id. at 20-21. The Department found that it was not necessary to resolve market structure issues before or during the investigation into NYNEX's Plan. Id. at 21.[12]

Specifically, the Department held that the scope of the proceeding would include, but not be limited to:

> (1) issues relating to economic theory of price regulation versus rate-of-return regulation; (2) specific components of the Plan, such as the term and pricing rules; (3) filing of new services and the standard of review for such filings; (4) service quality commitment levels and reporting requirements; (5) the scope and timing of infrastructure improvements; (6) the proposed rate freeze for residence basic exchange service; and (7) the proposed increase in the monthly credit for Lifeline customers.

Id. at 13-14, 22-23.

Finally, the Department determined that it would not conduct a full rate case before or during the investigation into NYNEX's

[12] The Department restated its commitment to fostering a competitive telecommunications market in Massachusetts and cautioned that it would not approve an alternative form of regulation for NYNEX that would give NYNEX an unfair advantage in a fully competitive market. June 14, 1994 Interlocutory Order at 21.

Plan, but would focus its review on the reasonableness of NYNEX's earnings to determine whether the current rates would be an appropriate starting point for implementation of a price cap. Id. at 22. With respect to the reasonableness of the Company's earnings, the Department stated that a review focused on the reasonableness of NYNEX's earnings would allow the Department to determine whether the current rates represent the appropriate starting point for implementation of the Plan. Id.. The Department stated that it would:

> limit its investigation on the issue of the Company's current level of earnings to an examination of whether: (1) the adjustments prescribed by the Department in D.P.U. 86-33-G have been properly reflected in the test year account balances presented in NYNEX's filing; and (2) the resulting rate of return on investment is reasonable.

Id.[13] The Department stated that if it should determine that the current rates were not an appropriate starting point, it might decide that a more detailed review was necessary. Id. The Department found that a review of NYNEX's revenue requirement, cost allocation, and rate structure was beyond the scope of the proceeding. Id.

The Department additionally noted that ongoing discussions may lead to a settlement of some or all of the issues surrounding local competition. Id. at 31. With respect to the Motions to Consolidate, the Department found that it would not be

[13] NET, D.P.U. 86-33-G (1989) was the Department's most recent determination of the Company's revenue requirement.

appropriate to consolidate its investigation of the Company's Plan with its ongoing investigation in D.P.U. 90-206/91-66. Id. The Department found that collocation and interconnection are essentially market structure issues, not pricing mechanisms, and that market structure issues would not be part of its investigation into the Company's Plan. Id.

With respect to NYNEX's Motion to Defer Transitional Filing, the Department found that it would be inefficient to continue with the transitional rate process while reviewing the Company's proposal for alternative regulation. Id. at 36. Therefore, the Department granted the Company's Motion to Defer Transitional Filing. Id. The Department noted that by granting the Motion, it was not abandoning the transitional process but rather deferring the process pending the outcome of its investigation into NYNEX's Plan. Id.

3. July 14, 1994 Interlocutory Order

On June 27, 1994, NYNEX filed a Motion for Clarification of the Department's June 14, 1994 Interlocutory Order, and NECTA filed a Motion for Reconsideration of that Order and a Motion for Stay of the procedural schedule. On June 30, 1994, the Attorney General filed a Motion in Response to the motions of NYNEX and NECTA, asking that the Department grant the motions of NYNEX and NECTA, hold that NYNEX bears the burden of proving that the Plan will yield just and reasonable rates, and hold that parties would have the right to inquire into and challenge any and all revenue requirement/cost of service issues as well as cost of capital issues.

On June 30, 1994, pursuant to a deadline established by the Hearing Officer, NYNEX filed a Reply to NECTA's Motions, NECTA filed a Reply to NYNEX's Motion, and AT&T filed a Response to the Motions of NYNEX and NECTA. The Department viewed NECTA's Motion, the Attorney General's Motion and the comments filed by AT&T as motions for clarification of the June 14, 1994 Interlocutory Order and treated them as such. NYNEX, D.P.U. 94-50, at 3 n.3, 4 nn.4-5 (July 14, 1994 Interlocutory Order) ("July 14, 1994 Interlocutory Order").

The Department clarified the scope of inquiry in the instant proceeding. Id. at 7. With respect to the earnings review, the Department granted the Company's Motion for Clarification and stated:

> the scope of inquiry into the reasonableness of NYNEX's current earnings as an appropriate starting point for the Plan will be as follows: (1) any matter concerning the reasonableness of the current level of earnings, including the Company's study period expenses, revenues, and investment, may appropriately be the subject of inquiry by parties in this proceeding either through cross-examination or by presentation of direct testimony by intervenors, jointly or severally; and (2) any party may seek to rebut the presumption that the Company's currently adjudicated and authorized rate of return is prima facie reasonable. Although the Department recognizes that intervenors may examine the Company's earnings, it hereby confirms that cost allocation and rate structure issues are beyond the scope of the present proceeding.

Id. The Department noted that should it determine in its final Order that NYNEX's rates are not the appropriate starting point for its Plan, further proceedings may be warranted. Id. at 8.

In addition, the Department confirmed that the burden of proving the reasonableness of the Company's current level of earnings as an appropriate starting point for the Plan remained with the Company. Id. at 18. Finally, the Department found that, although it would not resolve market structure issues in this docket, parties may present evidence regarding whether a certain level of competition is necessary before price regulation should be adopted.[14] Id. at 20.

4. July 22, 1994 Interlocutory Order

On June 28, 1994, Mark Brown appealed the Hearings Officers' denial of his late-filed petition to intervene as a full party. On July 22, 1994, the Department issued an Interlocutory Order upholding the Hearing Officers' ruling. NYNEX, D.P.U. 94-50 (July 22, 1994 Interlocutory Order).

5. September 19, 1994 Interlocutory Order

On August 23, 1994, the Attorney General appealed a Hearing Officer Ruling that sustained NYNEX's objections to the Attorney

[14] The Department defined market structure issues as, *inter alia*, interconnection, collocation, intraLATA presubscription, number portability, and unbundling. July 14, 1994 Interlocutory Order at 20.

General's Record Request No. 63, [15] which sought "a pro-forma cost of service per pole for pole attachments and ... all workpapers, calculations, formulas, and other supporting documentation to support the cost of service" (Tr. 13, at 64). The Hearing Officer determined that the issue was beyond the scope of the proceeding as defined in the Department's July 14, 1994 Interlocutory Order, since it related to cost allocation and rate structure, and because pole attachment rates are governed by a separate statute, G.L. c. 166, and are subject to specific regulations and procedures and, therefore, would be beyond the scope of even a traditional rate case (Tr. 13, at 69-70). The Department upheld the Hearing Officer's Ruling finding that the information was not "relevant for it would not tend to prove facts of consequence to issues material to the investigation." NYNEX, D.P.U. 94-50, at 10 (September 19, 1994 Interlocutory Order) ("September 19, 1994 Interlocutory Order").

6. September 22, 1994 Interlocutory Order

On July 27, 1994, the Attorney General appealed two Hearing Officer Rulings sustaining NYNEX's objections to record requests of the Attorney General and NECTA. On September 22, 1994, the

[15] Record requests are a method by which the Department allows a witness to respond to cross-examination in writing, where fault of memory or complexity of subject matter so require. (Ground Rule No. 3 (issued May 19, 1994; revised August 18, 1994)). The Ground Rules for the proceeding provide that record requests are not to be used as a substitute for discovery (id.).

Department issued an Interlocutory Order addressing the Attorney General's appeal. NYNEX, D.P.U. 94-50 (September 22, 1994 Interlocutory Order) ("September 22, 1994 Interlocutory Order"). The Attorney General's appeal concerned the following record requests related to the Company's investment commitments:

(1) RR-AG-26, which asked NYNEX to provide a cash flow analysis relative to MCI IR-1-16 (Exh. AG-316), assuming no deployment of video dial-tone;

(2) RR-AG-27, which asked NYNEX to provide a sensitivity analysis on the percentage of customers who would potentially subscribe to video dial-tone based on varying penetration rates of the expected deployment of 330,000 access lines;

(3) RR-AG-31, which asked NYNEX to provide a Massachusetts-specific intrastate cash flow analysis, similar to that in Exh. AG-316;

(4) RR-AG-35, which asked NYNEX to recalculate the "net present value" calculations and internal rate-of-return calculations on page 5 of Exh. AG-316, over a ten-year period;

(5) RR-NECTA-6, which asked whether the broadband network described in NYNEX witness Mr. Killian's testimony is planned to be part of a larger broadband network for other jurisdictions served by the Company; and

(6) An unnumbered NECTA record request, which asked the Company to provide NYNEX Corporation's Video Entertainment and Information Services Business Plan.[16]

September 22, 1994 Interlocutory Order at 2 n.3, citing, Tr. 6,

[16] On August 3, 1994, NECTA requested that the Hearing Officer reconsider the ruling sustaining the Company's objection to NECTA's unnumbered record request (Tr. 7, at 61, 87-88). On September 14, 1994, the Hearing Officer issued a written ruling denying that request. NYNEX, D.P.U. 94-50 Hearing Officer Ruling on NECTA Motion for Reconsideration at 8 (September 14, 1994).

at 17, 18, 38, 48; Tr. 7, at 61, 87-88.

In its September 22, 1994 Interlocutory Order, the Department determined that the evidentiary dispute surrounding the record requests primarily related to a difference in opinion among the parties as to whether the reasonableness of the Company's investment commitments was an issue in the proceeding. Id. at 17. The Department stated that the reasonableness of the Company's investment commitments was not an issue in the proceeding, and, therefore, the information sought through the contested record requests was not relevant to a material issue. Id. The Department noted that it had stated in the June 14, 1994 Interlocutory Order that only the issues of the scope and timing of the infrastructure improvements were within the scope of the proceeding and that none of the contested record requests related to the scope or timing of the Company's proposed infrastructure investments. Id. at 18. The Department noted that the investment commitments, although discussed in the Company's direct case, are not part of the actual alternative regulation framework for which the Department would make a determination of reasonableness. Id. at 19.

With respect to arguments made by the Attorney General and NECTA that the record requests related to issues of anticompetitive conduct, cross-subsidization, and charges to captive ratepayers, the Department stated that issues of anticompetitive conduct and cross-subsidization were clearly material to the investigation. Id. at 21. The Department stated that the requested cost/benefit and sensitivity analyses, the Company's marketing plan for its potential video services business, and the information requested in NECTA's sixth record request, were not relevant since they would not tend to prove facts of consequence to the issues material to the proceeding (e.g., misallocation of video-related costs to the Company's intrastate operating results). Id. at 21-22.[17]

In response to NECTA's argument that the information sought by the record requests was relevant to ROR issues, the Department acknowledged that ROR issues were clearly material to the case. Id. at 22. The Department maintained that NECTA had not shown how the information sought by the Attorney General's request for the Company to redo the cost/benefit and sensitivity analyses under different assumptions was relevant to investor perception of the Company's investment risk. Id. The Department stated

[17] The Department further noted that video dial-tone service is subject to exclusive regulation by the FCC, which has a comprehensive system of cost allocation rules and cost accounting safeguards to protect against cross-subsidization between regulated and unregulated services. September 22, 1994 Interlocutory Order at 21-22, citing In the Matter of Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58, 7 FCC Rcd 5781, 5820, 5827-29 (1992). The Department also stated that the FCC will "ensure that the risk of anticompetitive conduct is minimized" when it reviews local telephone companies' specific video dial-tone proposals in connection with the Section 214 certification process. Id..

that although a utility's particular capital projects may have some effect on investors' perceptions of the Company's financial risk, generally there is no strong link between a particular capital project and that perception of investment risk. Id. The Department found that given the limited nexus between the cost-effectiveness of the Company's investment commitments and investors' perceptions of the Company's investment risk, the information sought by the Attorney General and NECTA would not tend to prove facts of consequence to issues material to the proceeding. Id.

Finally, the Department noted the distinction between pre-hearing discovery and record requests. Id. at 23. The Department noted that its discovery procedures were guided by the broad standard in the Massachusetts Rules of Civil Procedure, while the ground rules for the proceeding provided that record request responses constituted sworn, written testimony that are part of the evidentiary record. Id. & n.27, citing Mass. R. Civ. P. 26 et seq.; Ground Rule No. 3 (issued May 19, 1994; revised August 18, 1994). The Department observed that the Hearing Officer could have sustained the Company's objections to the contested record requests on the additional ground that they constituted untimely discovery. Id. at 24.

7. November 7, 1994 Interlocutory Order

As discussed in the previous section, on July 19, 1994, the

Hearing Officer sustained the Company's objection to an unnumbered NECTA record request (Tr. 7, at 61, 87-88). On August 3, 1994, NECTA requested that the Hearing Officer reconsider the ruling sustaining the Company's objection to NECTA's unnumbered record request (NECTA Motion for Reconsideration, August 3, 1994). On September 14, 1994, the Hearing Officer issued a written ruling denying that request. NYNEX, D.P.U. 94-50, Hearing Officer Ruling on NECTA Motion for Reconsideration at 8 (September 14, 1994).

Notwithstanding the ruling, the Hearing Officer required the Company to provide the Department with a copy of the Video Entertainment and Information Services Business Plan for in camera inspection. Id. On September 16, 1994, the Hearing Officer stated in writing that in camera inspection of the Video Information and Entertainment Services Business Plan confirmed the Company's representations that the document did not contain relevant information (Procedural Notice, September 16, 1994). Also on September 16, 1994, NECTA filed an appeal of the September 14, 1994 Hearing Officer Ruling denying NECTA's Motion for Reconsideration. NECTA's appeal challenged the Hearing Officer Ruling on the grounds of relevance and procedural unfairness.

The NECTA record request was also the subject of a July 27, 1994 appeal filed by the Attorney General. See Section II.A.6, supra. As noted earlier, on September 22, 1994, the Department issued an Interlocutory Order on the Attorney General's appeal. One of the findings in that Interlocutory Order held that NYNEX Corporation's Video Entertainment and Information Services Business Plan, the subject of NECTA's unnumbered record request, was not relevant to the proceeding. September 22, 1994 Interlocutory Order at 24. On October 5, 1994, NECTA filed a Motion to Supplement the Record for purposes of its appeal of the Hearing Officer Ruling on NECTA's Motion for Reconsideration ("Motion to Supplement"). The Motion to Supplement requested that, in ruling on NECTA's appeal, the Department consider the Company's response to NECTA Record Request No. 31. NECTA Record Request No. 31 relates to costs of NYNEX's broadband initiative. The Hearing Officer granted NECTA's Motion to Supplement.

On November 7, 1994, the Department issued an Interlocutory Order addressing NECTA's appeal. NYNEX, D.P.U. 94-50 (November 7, 1994 Interlocutory Order) (" November 7, 1994 Interlocutory Order "). The Department found that NECTA Record Request No. 31 did not contain any information that the Department had not already considered in ruling on the Attorney General's appeal of the Hearing Officer ruling concerning the unnumbered NECTA record request, which was also the subject of NECTA's September 16, 1994 appeal. November 7, 1994 Interlocutory Order at 8 & n.6. Therefore, the Department found

NECTA's appeal on the issue of relevance moot since this issue was addressed in the September 22, 1994 Interlocutory Order. Id. at 8. The Department further found NECTA's arguments with respect to procedural unfairness without merit. Id. at 8-10. The Department denied NECTA's appeal. Id. at 10.

8. February 2, 1995 Interlocutory Order

As noted in Section II.A.2, supra, the Department, in its June 14, 1994 Interlocutory Order, deferred ruling on NECTA's second ground for dismissal, which raised the question of whether the Department had authority under existing statutes to review and approve NYNEX's Plan.[18] June 14, 1994 Interlocutory Order at 12. On February 2, 1995, the Department issued an Interlocutory Order on the second ground for dismissal cited in the NECTA Motion to Dismiss. In that Interlocutory Order, the Department found that it has the authority under G.L. c. 159 to permit alternatives to the ROR regulation model. NYNEX, D.P.U. 94-50, at 62 (February 2, 1995 Interlocutory Order) ("February 2, 1995 Interlocutory Order"). The Department further found that NYNEX had not failed to state a claim upon which relief could be granted in its petition for alternative

[18] On July 28, 1994, the Department issued briefing questions on the issue of the Department's authority to review and approve the Company's Plan. On August 25, 1994, the following parties submitted responses to those briefing questions: NYNEX, the Attorney General, AT&T, NECTA, and MCI.

regulation. Id. at 62, 66.

The Department noted that the intervenors raised concerns about specific elements of NYNEX's Plan (e.g., the term of the Plan, the amount of pricing flexibility provided by the Plan, specific anticompetitive aspects of the Plan, the starting rates, the level of the productivity factor, the lack of an earnings sharing mechanism, whether the transitional rate process should be continued, the mechanism for reviewing rates, the mechanism for reviewing new services, the pricing of access services, and the definition of pricing baskets) that the Department viewed as relating to deficiencies of particular elements of the Plan and not as to the Department's authority to review the Plan. Id. at 64 n.44. The Department stated that it would address these concerns in the Department's final Order. Id. These arguments are addressed, infra, in Sections VI and VII.

B. Pending Procedural Matters

Four procedural matters are pending before the Department: (1) NECTA's Motion for Partial Summary Judgment; (2) NECTA's Motion for Public Treatment of Proprietary Exhibits; (3) the Attorney General's Motion for Leave to Conduct Supplemental Discovery and Cross-examination on Whether NYNEX Is Intentionally Delaying the Sale of Bellcore; and (4) NYNEX's Motion to Move Late-filed Exhibit into Record and Inclusion of Errata Response to an Attorney General Exhibit, and the Attorney General's related Motion to Strike. We address these matters below.

1. NECTA's Motion for Partial Summary Judgment

a. Introduction

On September 28, 1994, NECTA filed a Motion for Partial Summary Judgment ("Motion") arguing that NYNEX's existing rates cannot be used as the starting rates for price regulation under the Company's Plan (Motion at 1). On October 11, 1994, in response to NECTA's Motion, NYNEX filed its Opposition and the Attorney General submitted comments. On October 17, 1994, NECTA filed a Reply to NYNEX's Opposition ("Reply").

b. Positions of the Parties

i. NECTA

In support of its Motion, NECTA contends that the Company's filing violates Department revenue requirement and cost allocation precedent because (1) the Company's 1993 test year operating results pre-date current rates, and (2) the cost allocators and billing determinants on which the current rates are based pre-date the test year (Reply at 1-2). NECTA states that by granting its Motion, the Department would eliminate the need for the parties and the Department to brief, review, and decide the reasonableness of NYNEX's earnings and to decide whether the Company's current rates are the appropriate starting point for implementation of alternative regulation (id. at 5-6). NECTA suggests that following adoption of an alternative form of regulation for NYNEX, the Company could propose other starting rates based on a proposed revenue requirement and cost allocators that match the proposed test year (id. at 5).

NECTA contends that its Motion is procedurally appropriate, that other parties have filed for partial summary judgment after commencement of Department hearings, and that the courts have ruled that a summary judgment motion in mid-trial is procedurally appropriate (id. at 2, citing Boston Edison Company , D.P.U. 906 (1982); Makino USA, Inc. v. Metlife Capital Credit Corp. , 25 Mass. App. Ct. 302, 317-18 (1988)). NECTA further states that the "evolving and changing scope of the proceeding would have made it impracticable for NECTA to have filed its Motion at an earlier point in the proceeding" (id. at 2). NECTA states that it has not previously moved for dismissal or partial summary judgment on the grounds offered in its Motion and that the Motion does not reargue prior claims rejected by the Department (id.).

NECTA states that under Department regulations and precedent, summary judgment is granted when there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law (Motion at 1, citing Altresco Lynn, Inc./Commonwealth Electric Company , D.P.U. 91-142/91-153, at 10 (1991); 220 C.M.R. § 1.06(6)(e)). With respect to the facts, NECTA argues that there is no dispute as to any material fact (NECTA Reply at 4). NECTA asserts that NYNEX does not dispute that the Company's existing rates (1) became effective in 1994 after the 1993 study period, and (2) are based on billing determinants and cost allocators from periods of time that precede the 1993 study period (id.).

NECTA further states that it is entitled to partial summary judgment as a matter of law (id. at 5). NECTA argues that, as a matter of law, the 1993 operating results cannot support the reasonableness of the existing rates, which (1) were not in effect in 1993, and (2) are based on a study period ending November 30, 1992 (Motion at 3-4). According to NECTA, the Company has not asserted that it has complied with Department test year and cost allocation standards (NECTA Reply at 5). NECTA argues that, contrary to the position taken by NYNEX, there is a "`specific regulatory prescription that govern[s] the uncontested facts'" (id., quoting NYNEX Opposition at 5-6 n.3). NECTA contends that the transitional filings made by the Company are not pertinent where a determination of revenue requirements and earned rate of return are at issue (id.).

NECTA states that under the July 14, 1994 Interlocutory Order, the scope of the proceeding includes all revenue requirements issues (id. at 3). NECTA contends that following issuance of the July 14, 1994 Interlocutory Order, the Company had to comply with the Department's cost allocation and revenue requirement precedent for purposes of proposing the existing rates as the starting rates for the Plan (Motion at 3). NECTA also asserts that following the July 14, 1994 Interlocutory Order, NYNEX elected to file only rate-of-return testimony (NECTA Reply at 3). NECTA argues that because the July 14, 1994 Interlocutory Order states that further proceedings may be necessary if it is determined that NYNEX's current rates are not the appropriate starting point for price regulation, the Department left open the issues that NECTA raises in this Motion (id. at 4, quoting July 14, 1994 Interlocutory Order at 8). Therefore, NECTA argues that its Motion cannot be properly characterized, as NYNEX suggests, as a motion for reconsideration (id. at 4).

NECTA cites the Department's Order in NET, D.P.U. 86-33-C (1987), the first phase of the Department's multi-year investigation into the Company's rates, which included the Company's method for its cost of service study ("COSS"), as support for its contention that the Company's filing violates the Department's cost allocation precedent (Motion at 2).

NECTA asserts that NYNEX has effectively proposed to change the cost allocation requirements and revenue requirements precedent (id. at 2-3). NECTA contends that with cost allocation excluded from consideration in the current proceeding, "NYNEX must be required to use the existing cost allocation requirements" (id. at 4-5).[19] NECTA states that given the

(continued...)

differences in demand for service, new service offerings, and changes in the number of local loops in service between the year ended November 30, 1992 and the year ended December 31, 1993, a mismatch exists between the current rates and the 1993 operating results (id. at 3).[20] NECTA further contends that because of the timeliness of certain cost allocation factors, NYNEX's cost studies may be no longer adequate or reasonable (id. at 4 n.2). NECTA states that failure to grant its Motion would be unfair because NYNEX's Plan is dependent on changes in cost allocation and revenue requirements precedent and parties have been prevented from seeking modifications to cost allocation requirements (id. at 6). NECTA contends that such inequity would constitute an error of law, an abuse of discretion, and arbitrary or capricious action (id.). NECTA contends that NYNEX's "non-compliance with revenue requirements precedent is [a]n independent legal basis for granting partial summary judgment" (id. at 5).

[19] (...continued)

[19] NECTA maintains its position, stated in previous pleadings, that "cost allocation methodology and scrutiny of the input data used to derive cost allocators should have been issues in this case" (Motion at 4 n.2).

[20] NECTA contends that the Company's existing rates are a "moving target" in light of tariff changes and new service offerings filed by NYNEX since the filing of the instant proceeding (Motion at 4 n.1). NECTA requests that the Department take administrative notice of these tariff filings or incorporate them by reference into the record (id.).

Finally, NECTA argues that granting its Motion would not prejudice NYNEX and cites a proprietary business plan in support of this assertion (Motion at 7, citing Exh. NECTA-201 Proprietary, App. 1).[21] NECTA contends that any delay cited by NYNEX is speculative and, in any case, would result from the Company's failure to comply with Department precedent on cost allocation and revenue requirements (NECTA Reply at 8).

ii. NYNEX

NYNEX argues that NECTA's Motion is repetitive of previously addressed arguments and is a procedural anomaly illustrative of NECTA's attempts to disrupt the proceeding (Opposition at 1-2). NYNEX notes that the Department has granted summary judgment where "the pleadings and filings conclusively show that the absence of a hearing could not affect the decision" (id. at 2, citing Altresco Lynn, Inc./Commonwealth Electric Company, D.P.U. 91-142/91-153 (1991); IMR Telecom, D.P.U. 89-212 (1990)). NYNEX states that the Department grants summary judgment if a review of the prefiled testimony, material obtained from discovery, and memoranda of the parties shows that there is no genuine issue as to any material fact (id. at 2-3).

NYNEX further argues that the Motion is an abuse of process with respect to its timing and reargument of claims previously

[21] In its Motion, NECTA cited Exh. NECTA-210, App. at 2, but the information appears in Exh. NECTA-201.

made (id. at 8-9). In particular, NYNEX states that summary judgment is a procedural mechanism to be employed in advance of hearings to obviate the need for hearings (id. at 8). The Company notes that NECTA filed the Motion after the close of evidentiary hearings on NYNEX's direct case and prior to the opening of hearings on intervenor direct cases, and states that the Company is unaware of any case in which the Department considered a motion for summary judgment filed at a time other than before hearings (id. at 9). NYNEX contends that the Motion is not based on any evidence or facts made evident only as the result of discovery or hearings (id.). NYNEX states that NECTA relies in its Motion on factual matters contained wholly within the Company's April 14, 1994 petition (id.).

NYNEX argues that, as a matter of law, NECTA is not entitled to the relief it seeks (id. at 3). NYNEX states that NECTA advanced the argument that the Company's existing rates are not the appropriate starting rates for alternative regulation in previously filed pleadings (id. at 3-4). NYNEX asserts that the Department addressed NECTA's argument in its June 14, 1994 Interlocutory Order which determined, among other issues, that the instant proceeding would include consideration of whether the Company's current rates are an appropriate starting point for the Plan (id. at 4, citing June 14, 1994 Interlocutory Order at 22). NYNEX contends that NECTA, through its Motion, seeks a reversal of the Department's previous finding that a review of the Company's 1993 earnings can establish the appropriateness of existing rates as a starting point (id. at 5). NYNEX argues that, in light of this, the Department could properly treat NECTA's Motion as a motion for reconsideration (id.).

The Company characterizes NECTA's arguments as assertions pertaining to factual conclusions the Department should draw from the record (id.). In addition, the Company contends that summary judgment is inappropriate to resolve disputed factual claims (id.). The Company asserts that the circumstances at hand differ from those where the Department has granted summary judgment (id. at n.3). Specifically, NYNEX states that the Department has granted summary judgment where there has been no factual dispute concerning a utility's violation of a "specific regulatory prescription" or an express Department regulation or threshold requirement (id.). NYNEX contends that there is no substantive law indicating that the Department must accept NECTA's view of the facts as a matter of law (id. at 6 n.3).

NYNEX disputes NECTA's factual conclusions as flawed (id. at 6). NYNEX argues that there is no mismatch between its existing rates and 1993 operating results because the existing rates were developed through a revenue-neutral transition process (id.). With respect to NECTA's arguments regarding cost allocation, NYNEX states that since the current rates are based on a comprehensive rate design investigation spanning many years, the Department reasonably may rely on the results of the last transitional case as a starting point for the Plan's rate design (id. at 7).

Finally, NYNEX states that there is no credibility to NECTA's claim that a grant of its Motion is in the public interest and would not prejudice the Company (id. at 10). According to NYNEX, the public interest is not served by deferring a ruling on the appropriateness of the Company's current rates as the starting point for the Company's Plan because (1) the Department has identified the reasonableness of the Company's 1993 earnings as being within the scope of the proceeding, (2) the 1993 earnings have been fully litigated, and (3) the issue can be decided within the proceeding (id.). NYNEX argues that the only interest served by granting NECTA's Motion would be NECTA's business interest (id.).

iii. Attorney General

The Attorney General notes that he has argued throughout the case that the Company's current rates cannot be used as a "just and reasonable" starting point for the Plan (Attorney General's Answer at 1). He states that his reason for so arguing is that the cost allocation and rate design data and methods on which the existing rates are based are over eight years old (id. at 1-2). The Attorney General contends that NECTA's Motion provides another ground for arguments previously made by the Attorney General with regard to the necessity to include cost allocation and rate design issues in the instant proceeding (id. at 2).

c. Standard of Review

The Department's procedural rules authorize the use of full or partial summary judgment in Department decisions. 220 C.M.R. § 1.06(6)(e). The rule specifically provides that "[a] party may move at any time after the submission of an initial filing for dismissal or summary judgment as to all issues or any issue in the case." Id. Summary judgment may be granted by an administrative agency where the pleadings and filings conclusively show that the absence of a hearing could not affect the decision. Massachusetts Outdoor Advertising Council v. Outdoor Advertising Bd. , 9 Mass. App. Ct. 775, 785-786 (1980); see also Hess & Clark, Div. of Rhodia, Inc. v. Food & Drug Admin. , 495 F.2d 975, 985 (1974).

In determining whether to grant a motion for summary judgment, the Department will review the initial pleadings, pre-filed testimony, responses to discovery, and the memoranda of the parties. IMR Telecom , D.P.U. 89-212, at 12 (1990). The Department has stated that summary judgment is appropriate if a review of the materials on file shows that there is no genuine issue as to any material fact, and the legal effect of the facts entitles either party to summary judgment. See Boston Gas

Company, D.P.U. 90-17/18/55, at 10 (1990) aff'd sub nom., Bertone v. Department of Pub. Utils., 411 Mass. 536, 538, 550 (1992); Hull Municipal Light Plant, D.P.U. 87-19-A at 25 (1990); IMR Telecom, D.P.U. 89-212, at 12 (1990).

d. Analysis and Findings

We first address the issue of the propriety of NECTA's Motion, specifically with respect to its timing and the bases offered in support of the Motion. The Department's procedural rules provide flexibility in the timing of motions for summary judgment by allowing a party to move for full or partial summary judgment at any time after submission of an initial filing. 220 C.M.R. § 1.06(6)(e). Therefore, a motion for summary judgment filed after the commencement of hearings is not per se an abuse of process. The Department has entertained a motion for partial summary judgment filed well into the procedural schedule of a case on at least one occasion. Boston Edison Company, D.P.U. 906, at 240 n.145 (1982). (In that case, the motion was disposed of in a footnote that contained no discussion of the propriety of the motion.)

NYNEX correctly notes that summary judgment is customarily used as a device to obviate the need for evidentiary hearings, as evidenced by Department Orders issued in the recent past addressing partial and full summary judgment. See AT&T/National Interactive Systems/CommNetics, Inc., D.P.U. 91-140, at 25

(1991); Altresco Lynn, Inc./Commonwealth Electric Company and Cambridge Electric Light Company, D.P.U. 91-142/91-153, at 15 (1991); Boston Gas Company, D.P.U. 90-17/18/55, at 11 (1990); Riverdale Mills Corporation, D.P.U. 86-209, at 15 (1990); Hull Municipal Light Plant, D.P.U. 87-19-A at 45 (1990), aff'd sub nom., Bertone v. Department of Pub. Utils., 411 Mass. 536, 538, 550 (1992); IMR Telecom, D.P.U. 89-212, at 18 (1990). In the instant proceeding, NECTA filed its Motion after the close of evidentiary hearings on the Company's direct case, including its direct case on earnings, seeking to dispose of the need for parties to review and brief, and for the Department to decide, earnings issues.[22] NECTA states that it would have been impracticable to file its Motion earlier in the proceeding. While the timing of the Motion does not violate Department rules or precedent, we note that the Motion could have been filed more appropriately in advance of hearings on earnings issues. On July 28, 1994 (the deadline set in the July 19 amended procedural schedule for the Company to file additional testimony on

[22] Contrary to NECTA's claims, the instant proceeding did not encompass a full revenue requirement investigation. The Department stated clearly in its July 14, 1994 Interlocutory Order that it would conduct an earnings review that would entail a review of the Company's earnings as set forth in the materials concerning revenues, investments, and expenses in its initial filing. July 14, 1994 Interlocutory Order at 7. Consistent with this review, the Department allowed intervenors to challenge the information presented on revenues, investments, and expenses (including the Company's return on investment). Id. at 17.

earnings), the Company filed cost of capital testimony. It was clear from the procedural schedule that the Department did not expect further earnings filings and, at the time the testimony was filed, it became clear that the Company would not be providing the sort of materials NECTA contends are required.

NECTA apparently interprets certain language in the Department's June 14, 1994 and July 14, 1994 Interlocutory Orders (indicating that should the Department determine that the Company's current rates are not an appropriate starting point, it may require a more detailed review) as a signal that the Department anticipated that it might find the earnings information deficient as filed. This is an incorrect reading of the Interlocutory Orders. The Department's view of the Company's filings as a sufficient basis for an earnings review is central to the determinations made in the June 14, 1994 and July 14, 1994 Interlocutory Orders. June 14, 1994 Interlocutory Order at 22; July 14, 1994 Interlocutory Order at 7-8. The Department's statements that further proceedings might be necessary indicated that the Department's view that a determination regarding the reasonableness of the Company's earnings and, in turn, the appropriateness of its current rates as a starting point, would depend on the information brought forth through the hearing process and the arguments made by parties on brief.

In short, apart from noting that the Company's rates resulted from a full adjudication in D.P.U. 86-33, D.P.U. 89-300, and the transitional filings, the Department took no position in the June 14, 1994 and July 14, 1994 Interlocutory Orders on the suitability of those rates as the starting point for the Company's Plan, if allowed. Rather, the Department expressly reserved judgment on the question of the suitability of the proposed starting point rates, but permitted the intervening parties to inquire into the matter. NECTA's construction of the Interlocutory Orders is not representative of what those Orders actually said.

NECTA makes two arguments in support of its Motion: (1) the test year operating results pre-date the effective date of the Company's current rates; and (2) the cost allocators and billing determinants used to justify the operating results pre-date the test year. NECTA had not previously moved for dismissal on either of these grounds. NECTA did, however, proffer essentially the same arguments earlier in the proceeding, albeit in the context of NECTA's Comments in Support of the Attorney General's Motion to Dismiss, [23] Motion for Reconsideration, and Comments on NYNEX's Motion for Clarification (see, e.g., NECTA's Comments in

[23] We note, however, that NECTA's comments on the Attorney General's motion are contained in the same pleading as NECTA's Motion to Dismiss, filed on May 11, 1994. The Department addressed the issues raised by NECTA's Motion to Dismiss in its June 14, 1994 and February 2, 1995 Interlocutory Orders.

Support of the Attorney General's Motion to Dismiss at 13-14 (May 11, 1994) (discussing need to determine cost allocation treatment of video dial-tone platform costs in present proceeding); NECTA Motion for Reconsideration at 5 (June 27, 1994) (arguing D.P.U. 86-33-G revenue requirements data are stale); NECTA Motion for Reconsideration at 6 n.* (arguing fact that test year earnings are not from a year in which current rates were in effect warrants dismissal); NECTA Comments on NYNEX Motion for Clarification at 2 (June 30, 1994) (arguing Company's burden of proof not met because earnings information offered is not based on current rates)).

As noted above, the Department has found in its Interlocutory Orders that a review of the Company's 1993 earnings provides a basis for determining whether the Company's current rates represent an appropriate starting point for alternative regulation. NYNEX correctly characterizes NECTA's Motion as arguing for a reversal of this determination made in the June 14, 1994 Interlocutory Order and affirmed in the July 14, 1994 Interlocutory Order. It is immaterial that NECTA specifically had not moved for dismissal on the ground stated in the Motion. The Department could, therefore, deny the Motion for Partial Summary Judgment on the sole ground that the Department has previously determined the issues raised. We will, however, discuss the substance of NECTA's arguments.

There is no dispute that the cost allocation and billing determinants relied on by the Company pre-date the test year and that the test year pre-dates the existing rates. The Department therefore must determine whether, as a matter of law, NYNEX's current rates cannot be used as the starting point for alternative regulation because of this. For the reasons stated below, we find that the legal effect of the undisputed facts that the test year operating results pre-date the effective date of the Company's current rates and that the cost allocators and billing determinants pre-date the test year does not entitle NECTA to partial summary judgment as a matter of law.

NECTA correctly notes that Department rate case precedent requires that cost allocators match the test year and that test year operating results match the rates they seek to justify. However, NECTA's argument regarding the legal effect of the facts is wrong.

First, the Company's current rates are the result of the revenue-neutral transitional rate process. This process moved rates toward a more cost-based footing but made no change to the Company's revenues. D.P.U. 93-125; D.P.U. 92-100; D.P.U. 91-30; D.P.U. 89-300. Because revenues did not change, the Company's earnings have not been affected by the 1994 change in rates resulting from the most recent restructuring. Therefore, the Company's use of 1993 operating results with rates that went into effect in 1994 does not affect the Department's ability to assess the reasonableness of earnings and of using current rates as a starting point for price cap regulation.

Second, this investigation is not a traditional revenue requirement investigation, nor a full rate case. The Department found that it was not necessary to conduct a full rate case in conjunction with, or prior to, its investigation of the Company's alternative regulation proposal. June 14, 1994 Interlocutory Order at 22. Instead, the Department determined that it would review the reasonableness of the Company's current earnings as a means of assessing whether the existing rates are an appropriate starting point for alternative regulation, or whether further proceedings are necessary. Id.; July 14, 1994 Interlocutory Order at 7. This proceeding is unique in that the Department has undertaken an assessment of earnings to see if the Company may be overearning.

Evaluating the Company's earnings position for the specific purposes of this investigation must perforce rely on techniques of rate case analysis. However, resorting to those techniques (the only ones that are generally recognized) to judge the possibility of overearning does not suggest that all rate case precedent and procedure should or must necessarily be deployed. While the Department generally has employed rate case precedent to examine the Company's filing and the adjustments proposed by intervenors, the nature of this investigation gives the Department flexibility to accept, as the basis for review, a filing in which the test year operating results pre-date the effective date of the rates and the cost allocators and billing determinants pre-date the test year.

In the circumstances of the present case, our acceptance of the Company's earnings filing as the basis for review has not compromised our ability adequately to assess the reasonableness of the Company's earnings and the appropriateness of the Company's current rates as starting rates for price regulation. Additionally, with respect to cost allocation, the Department has rejected arguments that the scope of the instant proceeding should include this issue. June 14, 1994 Interlocutory Order at 22; July 14, 1994 Interlocutory Order at 7.

For the above stated reasons and based on our review of the filings and pleadings in this case, the Department finds that NECTA is not entitled to partial summary judgment as a matter of law. Accordingly, NECTA's Motion for Partial Summary Judgment is denied.[24]

2. NECTA's Motion for Public Treatment of Proprietary Exhibits

On November 17, 1994, pursuant to 220 C.M.R. § 1.04(5),

[24] With respect to NECTA's request that the Department take administrative notice of tariff filings or incorporate them by reference into the record, we hereby incorporate such filings into the record for this proceeding.

NECTA filed a Motion for Treatment of Exhibits as a Part of the Public Record ("Motion"). Under G.L. c. 25, § 5D, the Department may protect certain materials from public disclosure. The Hearing Officer deferred ruling on the Motion until after receipt of NYNEX's report confirming which previously marked protected materials should be included in the public record. Subsequently, NECTA filed a letter requesting a limited exception to the deferral of a ruling for certain materials listed in its Motion (November 22, 1994 NECTA Letter to Hearing Officer).[25] NYNEX filed comments on NECTA's Motion and letter (NYNEX November 28, 1994 Comments).

On December 7, 1994, NYNEX and NECTA filed a letter reporting on discussions held at the direction of the Hearing Officer to resolve the matter and recommending that the Department take no further action on NECTA's Motion at that time (December 7, 1994 NYNEX/NECTA Letter Agreement at 1). NYNEX and NECTA stated that the Company would notify the Department under separate cover of exhibits previously designated proprietary that

[25] NECTA stated that it was requesting the exception to the deferral of a ruling on its Motion because NYNEX had precluded two NECTA signatories to the protective agreement executed by NECTA and NYNEX from reviewing certain proprietary exhibits (November 22, 1994 NECTA Letter to Hearing Officer). At the November 30, 1994 evidentiary hearing, the Hearing Officer ruled that NYNEX was required, under the terms of the protective agreement, to make those documents available to the NECTA signatories (Tr. 30, at 40).

should be part of the public record (id.). NECTA agreed to treat all previously designated proprietary material as confidential for the purposes of filing its brief (id. at 2). NYNEX agreed to notify NECTA and the Department within seven days of filing its reply brief if any portions of the briefs considered proprietary should be made part of the public record (id.). The letter further provided that NECTA could renew its motion in whole or in part only following such notification by NYNEX, or upon failure of NYNEX to provide such notice (id.). NYNEX and NECTA indicated that they believed that, ultimately, further action on the Motion may not be necessary (id.). Also on December 7, 1994, and under separate cover, the Company provided the Department with a list identifying exhibits previously treated as proprietary that should be placed into the public record (December 7, 1994 NYNEX Letter to Hearing Officer). [26]

In a letter to NECTA dated February 3, 1995, the Company identified the portions of the sealed record versions of NECTA's initial and reply briefs that should continue to be treated as confidential (February 3, 1995 NYNEX Letter to NECTA). NECTA did

[26] In addition, NYNEX identified by letter of December 7, 1994, those portions of the sealed transcripts for hearings held subsequent to July 20, 1994 that it sought to remain sealed. The Department hereby grants the request made in NYNEX's December 7, 1994 letter.

not seek to renew its Motion following receipt of this letter.[27] The Department therefore finds that it is not necessary to take further action on NECTA's Motion for Treatment of Exhibits as a Part of the Public Record.

3. Attorney General's Motion for Leave to Conduct Supplemental Discovery and Cross-examination on Whether NYNEX Is Intentionally Delaying the Sale of Bellcore

a. Introduction

On December 28, 1994, after initial briefs had been filed, the Attorney General filed with the Department a motion to reopen the record to allow for supplemental discovery and cross-examination of NYNEX relative to the reported plan of the seven Regional Bell Operating Companies ("RBOCs"), including NYNEX Corporation, to sell their ownership interests in Bell Communications Research ("Bellcore"), the RBOCS' research and engineering consortium ("Motion to Reopen"). The Motion to Reopen was similar to an October 17, 1994 motion filed by NECTA, although in the instant motion, the Attorney General indicated that he also sought to explore the issue of "whether NYNEX is intentionally delaying the sale of Bellcore." NECTA's Motion was

[27] On April 21, 1995, more than two months after NYNEX's February 3, 1995 letter, and more than four months after the December 7, 1994 Letter Agreement and NYNEX Letter to Hearing Officer, NECTA filed with the Department a letter requesting that the Department rule on its "pending motion." In that NECTA did not renew its request in a timely manner, we find that NECTA effectively waived its right to seek Department consideration of this matter.

denied (October 27, 1994 Hearing Officer Ruling at 4 (finding lack of good cause for supplemental discovery and cross-examination given speculative nature of request and prospect that additional examination would delay proceeding)).

Answers to the Attorney General's Motion to Reopen were filed by NYNEX, AT&T, NECTA, [28] and MCI. On January 18, 1995, the Attorney General and AT&T filed Replies to NYNEX's Answer. [29] With the permission of the Hearing Officers, NYNEX submitted a response to the replies of the Attorney General and AT&T. On January 31, 1995, without leave of the Department, NECTA filed a response to NYNEX. [30]

b. Positions of the Parties

i. Attorney General

The Attorney General contends that "credible information has come to light" that suggests that NYNEX is "improperly attempting

[28] On April 10, 1995, NECTA filed a motion again seeking the relief requested in its answer to the Attorney General's Motion to Reopen.

[29] Some of the responses filed were not contemplated by the January 7, 1994 Hearing Officer Notice setting forth comment deadlines. The notice had contemplated a reply only by the Attorney General; therefore, AT&T's additional comments were filed without leave.

[30] For purposes of ruling on the Attorney General's motion, the Department will consider the unsolicited comments of AT&T and NECTA. However, in future proceedings, parties must request permission to file additional comments or responses in order for such material to be considered by the Department.

to game the outcome of this proceeding by intentionally delaying the sale of Bellcore" and thus "withhold[ing] any and all benefits of [such sale] from its ratepayers" (Motion at 2-4). The Attorney General cites a December 16, 1994 Wall Street Journal article that reports that the RBOCs have hired an investment firm "to handle the possible initial public offering" of Bellcore and that NYNEX was delaying the sale of Bellcore until "approval of a controversial regulatory proposal in New York" (id. at 2-3). He suggests that NYNEX may also be withholding its approval for the sale until this case has concluded (id. at 3). The Attorney General states that the sale of Bellcore "would have a significant impact on the reasonableness of the revenue requirement and going in rates for price cap regulation," and therefore, the Department must allow parties to examine the issue (id., citing Exhs. NECTA-128, NECTA-185, NECTA-200). If "gaming" is in fact taking place, the Attorney General asserts that NYNEX should be reprimanded (id. at 4). Finally, the Attorney General argues that this additional investigation need not delay the Department's issuance of the final Order in this proceeding; the Department could remove the "Bellcore issue" from the case, and rule on it in a subsequent order (id. at 4 n.3).

The Attorney General also responds to NYNEX's suggestion that the Department adopt the same approach as the New York

Public Service Commission ("New York Commission") for treating this issue (i.e., the Department would retain ratemaking authority relative to Bellcore sale proceeds) [31] (Attorney General Reply at 3). The Attorney General contends that while such an approach represents a "first step," it lacks the mechanism for the Department and interested parties "to easily track future developments" related to the sale (id.). The Attorney General argues that the Department should rule that the ratemaking impact of any sale of Bellcore remain open to further investigation, and should adopt the so-called "six-point" NECTA proposal (which is described, infra) (id. at 2-3).

ii. NYNEX

NYNEX argues that nothing has changed in the status of the possible sale of Bellcore since the Hearing Officer's ruling on

[31] According to NYNEX, the New York Commission was asked to reopen hearings on its "Track II" investigation into performance-based incentive regulation for New York Telephone Company ("NYT") (Case 92-C-0665), based primarily on the same December 16, 1994 Wall Street Journal article referenced by the Attorney General in this proceeding (NYNEX Answer at 4). The Administrative Law Judges conditionally granted the motion to reopen but noted that further hearings would not be necessary if NYT agreed to preserve the New York Commission's authority to determine the ratemaking treatment of any proceeds from a Bellcore sale, notwithstanding any provision of the incentive plan approved in that docket (id. at 4-5, citing Proceeding on Motion of the Commission to Investigate Performance-based Incentive Regulatory Plans for New York Telephone, Case No. 92-C-0665, Ruling Conditionally Granting Motion to Reopen Hearings, (N.Y.P.S.C. January 4, 1995)). (The Attorney General filed a copy of that ruling with the Department on January 6, 1995.)

NECTA's Motion, and, therefore, the investigation called for by the Attorney General would be premature and speculative (NYNEX Answer at 3). In addition, the Company categorically denies the suggestion that it is gaming the regulatory process in Massachusetts and New York by allegedly delaying the sale of Bellcore (id. at 3-4). Nevertheless, as a show of its "good faith" and to avoid additional hearings, the Company recommends that the Department apply treatment similar to what the New York Commission decided in ruling on what NYNEX characterizes as "a virtually identical motion" (id. at 4, citing Proceeding on Motion of the Commission to Investigate Performance-based Incentive Regulatory Plans for New York Telephone , Case No. 92-C-0665). Thus, the Company agrees that if Bellcore is sold by its shareholders, the Department would retain the authority to determine the appropriate ratemaking treatment of any proceeds, notwithstanding any provision of an alternative regulation plan that might be adopted by the Department in this proceeding (id. at 6).[32] NYNEX calls this a "reasonable approach" that "satisfies fully" the Attorney General's concerns and eliminates

[32] NYNEX stated that the Department's authority in this matter would not be unqualified, but that the Company would be subject to the Department's statutory jurisdiction to dispose of any sale proceeds (NYNEX Answer at 6). The Company also asserts that it reserves the right to raise any objections it may have to the Department's exercise of its authority that the Company believes is in violation of the Department's statutory jurisdiction (id.).

the need for additional hearings (id. at 5-6).[33]

In addition, NYNEX contends that AT&T's suggestion that NYNEX agree to treat the proceeds of a sale of Bellcore as an exogenous cost change under the terms of any alternative regulatory plan approved for the Company is "unreasonable and unwarranted" and reflects an erroneous view of the Company's representations (NYNEX January 30, 1995 Response at 3). With regard to the Attorney General's suggestion that the Department should adopt NECTA's "six-point" proposal, the Company argues that such a recommendation exceeds the scope of the Attorney General's Motion to Reopen and is an inappropriate attempt at "the eleventh hour" to continue his study period expense examination (id. at 4). Finally, NYNEX claims that the Attorney General seeks to "predetermine" the outcome of a possible future ratemaking proceeding and "gain advantages" in such a proceeding, should NYNEX continue to be regulated under rate-of-return methods (id.).

iii. NECTA

[33] On January 12, 1995, the Company submitted a copy of a January 11th ruling by the Administrative Law Judges in the New York proceeding, in which it was determined that because New York Telephone had agreed to the retention of ratemaking authority by the New York Commission of any Bellcore sale proceeds, there was no need to reopen hearings. Proceeding on Motion of the Commission to Investigate Performance-based Incentive Regulatory Plans for New York Telephone , Case No. 92-C-0665, Ruling Denying Supplemental Motion for Conditionally Reopened Hearings , (N.Y.P.S.C. January 4, 1995).

NECTA contends that the Attorney General's Motion to Reopen is reasonable and should be granted (NECTA Answer at 1). NECTA argues that NYNEX's 1993 study period "includes millions of dollars of cost that Bellcore has charged to NYNEX ... [without any] showing that these costs are in any way representative of what NYNEX would incur on an annual basis following a sale of Bellcore" (NECTA January 31, 1995 Response at 1). Thus, NECTA claims, the Company's starting point rates include a "massive, nonrecurring expense, if Bellcore is sold" and will provide NYNEX with a "windfall" (id.).

If the Department decides not to hold additional hearings, NECTA proposes a "six-point" plan essentially designed to remove all impacts of Bellcore from the Company's study period revenue requirement and to provide for consideration of such impacts at a later time (NECTA Answer at 3). Among other things, NECTA suggests that the Department require NYNEX (1) to exclude Bellcore expenses from the Company's 1993 study period revenue requirement and defer recognition pending any sale; (2) to "create a subsidiary account for any 1993 and future earnings on the Bellcore investment;" and (3) to provide various reports on historical and future Bellcore investment, earnings, and expense amounts (id. at 3-4). In the event of a sale of Bellcore, NECTA recommends that the Department require NYNEX to "submit a complete accounting" of such a sale to the Department and to recommend the appropriate ratemaking treatment (id. at 4). NECTA contends that the Department could then hold hearings to determine how to account for Bellcore expenses, earnings, investment, and sale proceeds for ratemaking purposes (id.).[34]

NECTA argues that its suggestion, unlike AT&T's and NYNEX's recommendations, is the only way to protect ratepayers and ensure competition because it "addresses the legal and economic issues associated [with] the sale of Bellcore" through removal of the impact of Bellcore expenses on the Company's 1993 study period revenue requirement and by addressing the future ratemaking treatment of any sale (NECTA January 31, 1995 Response at 2).

iv. AT&T

AT&T supports the Attorney General's Motion to Reopen, citing the ruling by the Administrative Law Judges in the New York proceeding that conditionally reopened hearings (AT&T Answer). AT&T expresses concern about whether NYNEX's solution would "allow the Department to investigate fully any future sale of Bellcore and to adopt appropriate ratemaking treatment of the proceeds of any such sale" if NYNEX were operating under price cap regulation (id.). To clear up the uncertainty, AT&T suggests

[34] As noted earlier, on April 10, 1995, NECTA filed a Motion for Accounting and Other Relief Based upon Sale of Bellcore. NECTA argues in its Motion that, based on an April 6, 1995 Wall Street Journal article reporting that a final vote to sell Bellcore was imminent, the relief NECTA sought in its answer to the Attorney General's Motion to Reopen "is now more appropriate than ever" (NECTA Motion at 1-2).

that the Department should require NYNEX to agree that it will treat the proceeds from the sale of Bellcore as an exogenous cost change under any price cap plan, and thus "flow through" to ratepayers the benefits of such a sale (id. at 2). AT&T claims this would also "reduce the possibility of NYNEX later challenging [the Department's] authority to determine the disposition of the proceeds of a sale of Bellcore" (id.).

v. MCI

MCI supports the Attorney General's Motion to Reopen (MCI Answer at 1). MCI contends that the Department should either direct NYNEX to remove the effects of a possible sale of Bellcore from any price cap plan approved for the Company or reopen hearings to examine the impact of a sale as it bears on the issue of the reasonableness of the Company's starting rates (id. at 2-5).

c. Analysis and Findings

The Department's Procedural Rules allow for reopening of hearings, upon motion, for good cause shown. 220 C.M.R. § 1.11(8). The Department's "good cause" standard provides that:

> Good cause is a relative term and it depends on the circumstances of an individual case. Good cause is determined in the context of any underlying statutory or regulatory requirement, and is based on a balancing of the public interest, the interest of the party seeking an exception, and the interests of any other affected party.

Nunnally d/b/a L & R Enterprises , D.P.U. 92-34-A at 3 (1993), citing Boston Edison Company , D.P.U. 90-335-A at 4 (1992).

As noted, in ruling on a similar motion by NECTA in October 1994, the Hearing Officer found that it would be "premature" to hold hearings on the Bellcore issue given the "speculative information available to date." NYNEX, D.P.U. 94-50 Hearing Officer Ruling at 3 (October 27, 1994). The Hearing Officer also noted that such hearings would likely cause significant delay in the procedural schedule. Id. However, if "credible information comes to light showing that a sale of Bellcore is more definite," such as an agreement in principle, the Hearing Officer stated that the Department may allow for additional hearings. Id. The December 16, 1994 Wall Street Journal article that formed the basis of the Attorney General's Motion to Reopen does not indicate that a sale is any more definite than was the case at the time of NECTA's motion. Indeed, it may be doubted whether untested newspaper articles or broadcast reports -- without more admissible evidence to corroborate them -- can support a showing of good cause. In any event, the article in question falls short of asserting that the disposition of Bellcore has been concluded. The April 6, 1995 Wall Street Journal article cited in NECTA's April 10, 1995 Motion does provide more definite information, but does not provide a clear date of sale. [35] Therefore, the Department finds that there is not sufficient credible information to necessitate additional hearings at this time on the general issue of a possible sale of Bellcore.

The Attorney General and other intervenors also have alleged that NYNEX Corporation may be "gaming" the regulatory process (i.e., intentionally delaying sale of Bellcore until the completion of incentive regulation proceedings in Massachusetts and New York) and that the Department should open hearings to examine this issue. Again, the sole basis of this otherwise unsupported allegation is the December 16, 1994 Wall Street Journal article. While the Department views such allegations as serious, we cannot base our investigations on mere allegations alone, particularly those supported only by an uncorroborated newspaper report. [36] Moreover, the determinations of the New York Commission, while instructive, are not controlling on the Department's regulation of NYNEX. See Proceeding on Motion of the Commission to Investigate Performance-Based Incentive

[35] Following NECTA's April 10, 1995 Motion, an article appeared in Telecommunications Reports noting an April 13, 1995 Bellcore press release, which indicated that a final decision regarding disposition of Bellcore was "`subject to obtaining satisfactory financial and other terms and necessary approvals.'" Telecommunications Reports, April 17, 1995, at 3.

[36] Contrary to the intervenors' arguments, whether NYNEX has or has not publicly denied the newspaper account is not controlling.

Regulatory Plans for New York Telephone Company, Case No. 92-C-0665, Ruling Conditionally Granting Motion to Reopen Hearings (January 4, 1995). As with the findings above regarding the general issue of a possible sale of Bellcore, the Department finds that the Attorney General's request for additional hearings on this issue fails for a lack of sufficient credible information. For the same reason, the Department rejects NECTA's so-called "six-point" proposal.

Notwithstanding this ruling, the Department notes that NYNEX has offered to abide by certain representations regarding the ratemaking treatment related to a future sale of Bellcore. Specifically, NYNEX has represented that if Bellcore is sold by NYNEX Corporation's shareholders, the Department would retain the authority to determine the appropriate ratemaking treatment of any proceeds, notwithstanding any provision of any alternative regulation plan that might be adopted by the Department in this proceeding. NYNEX has determined that it is in the Company's best interests to make these representations, and the Department will expect the Company to abide by them. See also G.L. c. 268, § 6. We direct the Company to advise the Department in writing of any such sale of Bellcore at the time of sale. Such notification should include the terms of the sale. The Department will then determine the appropriate course of action regarding the ratemaking treatment of any proceeds from the sale of Bellcore.

Based on the above analysis, the Department finds that the Attorney General has not demonstrated good cause for its Motion to reopen hearings, or in the alternative, to accept NECTA's "six-point" proposal. Therefore, the Department denies the Attorney General's Motion to Reopen. [37]

4. NYNEX's Motion to Move Late-filed Exhibit into Record and Inclusion of Errata Response to an Attorney General Exhibit, Attorney General's Motion to Strike [38]

a. Introduction

This evidentiary dispute concerns information regarding (1) the costs associated with the Company's work force reduction costs as part of its Process Re-engineering ("PRE") Initiative and (2) a correction to an Attorney General exhibit dealing with travel, meals, and entertainment expenses.

In a footnote to its initial brief, NYNEX moved for inclusion in the evidentiary record of the Company's response to information request IBEW IR-1-24 (NYNEX Brief at 193 n.50). The Company included the information response and a worksheet in an appendix to its initial brief (id., App. E). According to the

[37] For the same reasons, we also deny NECTA's April 10, 1995 Motion (in that it sought the same relief as the Attorney General's Motion).

[38] In light of the relief the Attorney General seeks in his reply brief regarding NYNEX's Motion and inclusion of an errata to Exhibit AG-509, we will treat the Attorney General's comments as a Motion to Strike.

Company, IBEW IR-1-24 contains data supporting the Company's contention that, as a result of the agreement reached last fall with the IBEW union, it will incur work force reduction-related costs greater than those initially contained in its filing (id. at 193).

The Company also referred in its initial brief to an error made in preparation of Exhibit AG-509, which provides a list of travel, meals, and entertainment expenses over $1,000 related to its Massachusetts operations and included by the Company in its 1993 operating results (id. at 212). The Company included an affidavit or "errata" in an appendix to its initial brief (id. at App. F).

b. Positions of the Parties

i. Attorney General

The Attorney General argues that NYNEX's attempt to introduce additional evidence through attachments to its brief is unfair and contrary to Department rules and precedent (Attorney General Reply Brief at 34). He cites the Department's own procedural rule that "no person may present additional evidence after having rested nor may any hearing be reopened after having been closed, except upon motion and showing of good cause" (id., citing 220 C.M.R. § 1.11(8)). The Attorney General contends that the Department has held that "it would be fundamentally unfair to admit ... [additional evidence] without the opportunity for cross examination" (id. at 34-35, citing Boston Gas Company , D.P.U. 93-60-E at 9 (1994); Payphone Inc. , D.P.U. 90-171 (1991)). The Attorney General also argues that, by placing new evidence in its initial brief, NYNEX has failed to follow standard Department procedure, which, he maintains, requires that a party offering a late-filed exhibit must first move to reopen the record to introduce new evidence prior to producing such evidence (id. at 35, citing Boston Gas Company , D.P.U. 88-67, Phase II, at 7 (1989)).

With respect to IBEW IR-1-24, the Attorney General states that NYNEX's claim of insufficient notice regarding amortization of PRE costs is not a basis for referring to extra-record material on brief (id. at 35 n.25). With respect to the travel, meals, and entertainment expenses, the Attorney General argues that, under Department precedent, it is irrelevant that NYNEX has characterized the affidavit and accompanying information as an errata (id.).[39]

He claims that "[r]eferring to such extra-record material on brief is ... prejudicial to parties who cannot challenge the late-filed information through cross-examination" (id.). The Attorney General argues that the late-filed exhibit should not be

[39] The Attorney General notes that the evidentiary record contains documentation of only those travel, meals, and entertainment expenses in excess of $1,000 (Attorney General Brief, Part II, at 44 n.27).

allowed into the record, and that the Department should strike the references in NYNEX's initial brief to IBEW IR-1-24 on page 193 and to the affidavit and information contained in Appendix F on page 212 (id. at 35). Finally, the Attorney General argues that the Department should rule against NYNEX on all issues addressed by IBEW 1-24 and the affidavit and other documents pertaining to travel, meals, and entertainment expenses (id. at 35-36).

ii. NYNEX

In its motion, the Company contends that IBEW IR-1-24 was not marked as an exhibit and entered into the record "because the Company had no notice that amortization of PRE implementation costs was an issue" (NYNEX Brief at 193 n.50). The Company claims that the Attorney General first argued for amortization of PRE costs in his initial brief (NYNEX Reply Brief at 56). Moreover, NYNEX maintains that including the information response in the record at this point would not result in prejudice to any party (id.). The Company asserts that the Attorney General had a copy of the information response well before finishing his cross-examination of NYNEX's earnings witness and, thus, had the opportunity to cross-examine NYNEX on the information response (id. at 56-57).

With respect to Massachusetts travel, meals, and entertainment expenses, the Company states that the itemized list of such expenses over $1,000 provided in Exhibit AG-509 contains certain nonrecoverable expenses that were not actually included in the test year cost of service (NYNEX Brief at 211-212). The Company noted that it made a similar error in preparation of Exhibit AG-511, an itemized list of travel, meals, and entertainment expenses charged to the Company by its affiliates (id. at 212). NYNEX argues that, because it is a correction of an error, the affidavit provided in Appendix F of its initial brief does not constitute additional evidence (NYNEX Reply Brief at 55). NYNEX states that to characterize the affidavit as additional evidence would be to elevate form over substance (id.). NYNEX argues that none of the concerns underlying the Department's precedent regarding extra-record evidence exist with respect to the affidavit (id.). Specifically, NYNEX argues that none of the parties would be prejudiced by allowing the correction (id.). NYNEX argues that the Department should not ignore that the Company's 1993 operating results properly excluded certain expenses (id. at 56).

c. Analysis and Findings

The Department's Procedural Rules state that "[n]o person may present additional evidence after having rested nor may any hearing be reopened after having been closed, except upon motion and showing of good cause." 220 C.M.R. § 1.11(8). In addition, the Ground Rules in this case provide that:

> Exhibits offered after the close of the hearings, if objected to by any party, labor under a heavy burden of untimeliness, for they would not be subject to cross-examination or rebuttal. _Late filed exhibits must be accompanied by a motion to reopen the record and supported by appropriate affidavits_. Only for good cause shown, in the face of an objection, will such exhibits be marked and admitted into evidence.

Ground Rules at 3-4 (Revised August 18, 1994) (emphasis added).

The Department set forth its policy on late-filed exhibits in _Boston Gas Company_, D.P.U. 88-67, Phase II (1989) ("_Boston Gas Phase II_"), stating:

> A party's presentation of extra-record evidence to the fact-finder long after the record has closed and after all briefs have been filed is an unacceptable tactic, potentially prejudicial to the rights of other parties even when the evidence is ultimately excluded. Facts or allegations of facts, once learned, cannot readily be unlearned .... In the future, once the record in a docket has closed, proper procedure will require that a party seeking to offer a late-filed exhibit or testimony move to reopen the record to introduce new evidence. (An exception is the Department's practice to permit updating of routine information already provided on the record -- for example, the most recent property tax bills -- or to permit filing responses to outstanding record requests.) The motion should state the subject or issue that the proffered exhibit or testimony would address. Only if such a motion were granted by the hearing officer, would it then be proper to present the exhibit or testimony itself.

Boston Gas Phase II at 7 (1989).

The Department has stated that the objectives of the procedure set forth in _Boston Gas Phase II_ are to eliminate unfair prejudice where a party does not have the opportunity to anticipate the offering of evidence and to prevent the potential prejudice that results from the fact-finder's exposure to information before a decision is made to reopen the record. Berkshire Gas Company, D.P.U. 90-121, at 12-14 (1990); see also Bay State Gas Company, D.P.U. 89-81, at 47-48 (1989) (filing of updated information late in the suspension period increases the risk of decision-making on a record insufficiently tested through litigation and review); Boston Edison Company, D.P.U. 89-1A-1, at 6-7 (1989) (admissibility of late-filed exhibit moot where document not relied on or considered in reaching decision; noting approval of Hearing Officer's directive that Company resubmit initial brief without reference to proposed exhibit and without arguments related to exhibit); cf. MFS-McCourt, Inc., D.P.U. 88-229/252, at 9 (1989) (allowing inclusion in record of late-filed exhibits even though opposing party had not had opportunity to cross-examine the new evidence, because no prejudice to the moving party would result from admission).

i. IBEW IR-1-24

As a threshold matter, NYNEX's motion to include the response to IBEW IR-1-24 in the evidentiary record is procedurally deficient when measured against the Department's rules and precedent regarding late-filed exhibits. Although the Company moved to admit the information response as an exhibit, it did not file a motion to reopen the record, as required by Boston Gas Phase II, the Department's procedural rules, and the Ground Rules for this proceeding. In addition, the Company's motion for admission was not accompanied by a supporting affidavit, as required under the Ground Rules. The Company's motion could be denied on the sole basis of its procedural deficiencies.

In addition to these procedural deficiencies, the Company's reasons for introducing the late-filed evidence are unpersuasive. The Company, consistent with its burden in this proceeding of demonstrating the reasonableness of its earnings, was required to provide proof of all relevant costs in its test year. On the first day of hearings regarding NYNEX's earnings, the Company's witness testified that ratification of an agreement with the IBEW would have a "substantial impact on the costs of work force reductions" (Tr. 9, at 26). Some three months prior to the close of evidentiary hearings during cross-examination on Exhibit AG-543, an information response eventually admitted into evidence, the same witness testified that, following ratification of the IBEW agreement, the Company's pension enhancement obligations would increase significantly and, therefore, amounts used in his prefiled testimony would change as well (Tr. 13, at 77-79). The relationship between the response to IBEW IR-1-24 and the Company's work force reduction costs is not entirely clear merely from looking at the response. It appears that the Company included the worksheet accompanying IBEW IR-1-24 in Appendix E to clarify the effect of the amounts of the Company's work force reduction costs provided in the response to IBEW

IR-1-24.[40] Consistent with its burden of proof and obligation to update information responses, the Company should have updated its earnings filing and related discovery responses at the time the new contract was reached.[41] See 220 C.M.R. § 1.06(6)(c)(5) (petitioner has a continuing duty to amend discovery responses).

The issue of how to treat the Company's work force reduction costs for ratemaking purposes (i.e., whether to expense or amortize the costs) is beside the point. Even if the Attorney General had not argued for amortization of work force reduction costs, the Department would have considered the appropriate ratemaking treatment, including the propriety of amortization, as it would for any dollar amount (See Section VII.C.1.f, infra, for a discussion of the Department's findings on this issue).

Finally, NYNEX is wrong in suggesting that including the information response in the record at this point would not result in prejudice to any party. The Department's case law on late-filed exhibits is based on the premise that late-filed exhibits are prejudicial because other parties do not have the opportunity to conduct cross-examination regarding information

[40] We note that the worksheet relates amounts listed in IBEW IR-1-24 to amounts provided in Exhibit AG-543.

[41] As a result of the agreement reached with the Company, the IBEW filed a request to withdraw its participation in the proceeding on September 8, 1994. This request was granted on September 16, 1994. The Company could have updated its earnings filing and related discovery responses nearly three months prior to the close of hearings.

contained in late-filed exhibits in order to test the accuracy of the data through the litigation process.

No direct testimony was taken or cross-examination conducted relative to IBEW IR-1-24. The Company provided the specific dollar amount reflecting a change in the Company's pension enhancement obligations resulting from its IBEW contract for the first time in its initial brief, nearly one month after the close of evidentiary hearings. As noted above, the significance of IBEW IR-1-24 is not entirely clear on its face. Although, as NYNEX suggests, the Attorney General had received a copy of the information response early on in the case, the explanatory worksheet included in Appendix E was not provided until after the close of hearings. Admission into evidence of the information response and the worksheet would prejudice parties. See Boston Gas Company, D.P.U. 93-60, at 8-9 (Interlocutory Order) (September 29, 1993) (denying admission of update due to scant review accorded issue during hearings, magnitude of proposed change, and lack of notice to the Department and parties); Boston Edison Company, D.P.U. 90-335, at 7-8 (1992) (disregarding evidence presented for first time on brief); Payphone, Inc., D.P.U. 90-171, at 4-5 (1991) (fundamentally unfair to admit evidence not subject to cross-examination); Berkshire Gas Company, D.P.U. 90-121, at 12-14 (1990) (one objective of procedural safeguards established in Boston Gas Phase II is to eliminate undue prejudice where party has not had reasonable opportunity to anticipate offering of evidence); Bay State Gas Company, D.P.U. 89-81, at 47 (1989) (filing of updated information late in suspension period increases risk of decision-making on a record insufficiently tested through the process of litigation and review).

For all of the above reasons, we deny the Company's motion to introduce the response to IBEW IR-1-24 and the accompanying worksheet into evidence as a late-filed exhibit. In addition, we grant the Attorney General's motion to strike references to the data contained in the information response from NYNEX's initial brief at page 193, and Appendix E, and we will disregard these references. Finally, we deny the Attorney General's request that the Department rule against the Company on all issues related to IBEW IR-1-24. Our determination regarding the Company's work force reduction costs and the appropriate ratemaking treatment is based on the record and briefs, as modified by this ruling, i.e., exclusive of the response to IBEW IR-1-24 and arguments based on that excluded evidence. See Section VII.C.1.f, infra.

ii. Appendix F Affidavit

Department precedent provides for exceptions to its late-filed exhibit policy and specifically provides such an exception for updating of routine information already on the record. See Boston Gas Phase II at 7. We first address the issue of whether the affidavit falls within the update exception to the Department's procedures for late-filed exhibits.

The Department has stated that "post-hearing evidentiary submissions should be limited to updates and should not include substantial changes." Berkshire Gas Company, D.P.U. 90-121, at 15 (1990). The Department has further stated that updates include routine, anticipated, verifiable changes such as property tax updates or uncontested billing and related adjustments. Berkshire Gas Company, D.P.U. 90-121, at 15-16 (1990); Bay State Gas Company, D.P.U 89-81, at 48 (1989).

The affidavit offered by NYNEX is more in the nature of a clarification or correction than an update. The discovery response was marked for identification as Exhibit AG-509 during the evidentiary hearings and, together with a related exhibit (Exh. AG-511) concerning travel, meals, and entertainment expenses charged to the Company by affiliates, was the subject of cross-examination (Tr. 17, at 45-52). The affidavit is not a substitute for the originally filed information response, nor does it propose a change to the contents of the response. Also, the affidavit is distinguishable from property taxes and materials previously received in evidence as updates, because the Company did not provide notice of an expected change, nor would the parties have anticipated such. Therefore, we find that the affidavit contained in Appendix F does not constitute an update within the late-filed exhibit precedent.

In light of our determination that the affidavit is not an update, the Company's failure to file a motion to reopen the record is a procedural error. Boston Gas Company , D.P.U. 93-60, at 9 (Interlocutory Order) (September 29, 1993); 220 C.M.R. § 1.11(8); Ground Rules at 3-4 (Revised August 18, 1994). As noted above, parties have a duty seasonably to amend discovery responses. 220 C.M.R. § 1.06(6)(c)(5). The Company has stated that it made the same type of error in preparation of two related exhibits.[42] The Company addressed the error in Exhibit AG-511 by filing an errata response during the hearing phase of the proceeding. The Company should have discovered the error in Exhibit AG-509 and amended that response at the time it filed the errata response to Exhibit AG-511. Nevertheless, the particular circumstances here are analogous to cases where the Department has allowed entry of late-filed exhibits into the record, and distinguishable from cases where the Department has denied admission of late-filed exhibits.

As noted above, the Department's procedural requirements concerning late-filed exhibits are aimed at preventing prejudice to other parties and the fact-finder. Circumstances present in

[42] As stated in Section II.B.4.b.ii, the error was the inclusion in the itemized lists of travel, meals, and entertainment expenses over $1,000 of certain nonrecoverable expenses that were not actually included in the test-year cost of service.

this case relieve the concerns about prejudice to other parties and about compromising the fact-finder that underlie the Department's late-filed exhibit policy.

First, with respect to prejudice to other parties, the information in Exhibit AG-509 appears on the evidentiary record for the first time before the close of hearings. In fact, Exhibit AG-509 was used as a basis for questions during hearings. Parties to this case have had the opportunity to explore issues raised by Exhibit AG-509 through discovery and cross-examination, and the Attorney General did cross-examine the Company's witness regarding Exhibit AG-509 (Tr. 17, at 46-54). Cf. Bay State Gas Company, D.P.U. 89-81, at 47 (1989) (hearing time, though minimal, was sufficient to explore issue). Further, in view of the nature of the information in the record on travel, meals, and entertainment expenses, the Company has not proposed an impermissible "substantial" change.[43] Rather than submitting a substitute response, the Company offered the affidavit to clarify which items listed in Exhibit AG-509 were included in the cost of service. In addition, notwithstanding the availability of this information to the Company at an earlier date, the affidavit does

[43] We note that the information in the record concerning travel, meals, and entertainment provides a subset of the total included in the cost of service -- only those items in excess of $1,000 (Tr. 17, at 49). Therefore, as the Attorney General has noted, the figure arrived at by summing the items in Exhibits AG-509 and AG-511 is a representative, and conservative, figure.

not propose a modification to the Company's expenses of the magnitude contained in IBEW IR-1-24 or in other cases where the Department has denied late-filed exhibits. See, e.g., Boston Gas Company, D.P.U. 93-60, at 2, 9 (Interlocutory Order) (September 29, 1993) (rejecting an update that proposed a 409 percent increase over a figure provided in the initial filing).

Second, with respect to potential compromising of the fact-finder, we note that our conclusions reached in Section VII.C.3, infra, regarding ratemaking treatment for travel, meals, and entertainment are neither dependent on the total amount derived from AG-509 and AG-511, nor affected by NYNEX's inclusion of the affidavit in its initial brief. We find, therefore, that the affidavit is an added piece of information that merely sheds light on the calculation of travel, meals, and entertainment expenses included in the test year. Berkshire Gas Company, D.P.U. 90-121, at 13 (1990). The Department further finds that doubts about the irregularity of the Company's timing in presenting the contested information are outweighed by the parties' opportunity to pursue issues related to Exhibit AG-509 through the hearing process (Tr. 17, at 46-54). Id. at 14.

Therefore, the Department finds that inclusion of the affidavit in the record and references to the affidavit contained in the Company's initial and reply briefs does not result in material prejudice because (1) the affidavit clarifies which items listed in the exhibit were included in the cost of service, (2) parties had the opportunity to cross-examine the Company's witness on the exhibit and explore issues related to it in hearings, and at least one did, and (3) the Department's decision on the merits of the Attorney General's proposed adjustment is not dependent on the determination of the correct dollar amount to be derived from the exhibits. For all of the above reasons, the Department denies the Attorney General's Motion to Strike the affidavit contained in Appendix F and the references to that information on page 212 of the Company's initial brief.

We emphasize that our determination to admit the affidavit is based on the particular circumstances of this case and otherwise affirm the late-filed exhibit policy enunciated in Boston Gas Phase II . A party is in the best position to evaluate the accuracy of the information it presents through discovery. By failing seasonably to amend discovery responses, a party bears the risk that its own errors may be incorporated into the evidentiary record or of being denied the opportunity to correct those mistakes after the record is closed. There must be a finality to proceedings. Payphone, Inc. , D.P.U. 90-171, at 5 (1991).

Finally, the Department denies the Attorney General's request that it rule against the Company on all issues addressed by the affidavit. Our determination of the level of the

Company's travel, meals, and entertainment expenses is based on the record evidence and the arguments presented by the parties on brief.

III. THE COMPANY'S PLAN

A. Description

NYNEX's proposed Plan contains several primary components: (1) alternative regulation price rules; (2) streamlined tariff filing review procedures; (3) elimination of earnings regulation; (4) increased Lifeline discount; (5) commitment to Federal Communications Commission ("FCC") depreciation "lives;" and (6) voluntary infrastructure commitments[44] (Exh. NYNEX-1). The Company proposes that the Plan be in effect for a minimum period of ten years following approval by the Department (id. at 10). However, NYNEX also proposes that the Company, or any other party may petition the Department to modify any of the terms or conditions of the Plan (1) to reflect the impact of federal or state legislation or court decisions enacted or issued subsequent to the Department's approval of the Plan; or (2) to seek a less

[44] The Department previously has found that the reasonableness of the Company's voluntary investment commitments is not at issue in this proceeding and that the investment commitments are not part of the actual alternative regulatory methodology for which the Department must make a determination of reasonableness in the final Order in this proceeding. September 22, 1994 Interlocutory Order at 17-18. Only the scope and timing of the investments were determined to be within the scope of the proceeding. Id. Therefore, we will not summarize the investment commitments here but will address them in Section V.C.

structured form of regulation or deregulation of its operations based upon changes in market conditions (id.).

Under the Plan, the Company's prices would be governed by five price rules (described, infra) (Exh. NYNEX-4, at 2). The Company would make an annual filing to report on compliance with the pricing rules. The first filing would be made on June 1, 1995, with any associated price changes effective on August 15, 1995 (id.).

On July 11, 1994, the Company filed an amendment to clarify that the Plan was not intended, among other things, to limit competitors in their ability to seek interconnection arrangements from the Company (Exh. NYNEX-5) (see n.3, supra).

B. Indices

The proposed price rules are defined, in part, in reference to several indices: (1) actual price index; (2) price regulation index; (3) actual rate element index; and (4) rate element index.

1. Actual Price Index

> The Actual Price Index ("API") reflects the actual average percent change in aggregate prices implemented by NYNEX. The API initially would be set at 100 based on the Company's rates effective immediately before approval of the Plan. The API is calculated as follows:
>
> $$API_{new} = API_{current} * (1+API\ adjustment/100)$$
>
> where API adjustment = overall weighted average percent change in prices for all tariffed services.

2. Price Regulation Index

The Price Regulation Index ("PRI") reflects the percent change in the Gross Domestic Product-Price Index ("GDP-PI") minus the productivity factor, plus or minus exogenous changes. The PRI initially would be set at 100 and is calculated as follows:

$$\text{PRI}_{\text{new}} = \text{PRI}_{\text{current}} * (1+\text{PRI adjustment}/100)$$

where PRI adjustment = percent change in GDP-PI minus the productivity factor, plus or minus exogenous changes.

3. Actual Rate Element Index

The Actual Rate Element Index ("AREI") reflects the actual percent change implemented by NYNEX in the price for each rate element. The AREI initially would be set at 100 based on the Company's rates effective immediately before approval of the Plan and is calculated as follows:

$$\text{AREI}_{\text{new}} = \text{AREI}_{\text{current}} * (1+\text{AREI adjustment}/100)$$

where AREI adjustment = percent change in the price of each rate element. For elements that represent a rate credit, the AREI adjustment is multiplied by -1.0.

4. Rate Element Index

The Rate Element Index ("REI") reflects the percent change in the Consumer Price Index ("CPI"), plus or minus exogenous changes, and, for applicable rate elements, plus or minus the change in average usage per line.[45] The REI initially would be set at 100 and is calculated as follows:

$$REI_{new} = REI_{current} * (1+REI\ adjustment/100)$$

where REI adjustment = percent change in CPI, plus or minus exogenous changes, and, for applicable rate elements, plus or minus the change in average usage per line.

(Exh. NYNEX-1).

C. Pricing Rules

1. First Pricing Rule

Under the first pricing rule, the API must be equal to or less than the PRI (id. at 11). This rule would govern the allowable change in the weighted-average price of all tariffed services by placing a ceiling on that change (Exh. NYNEX-4, at 2). As noted, supra, the PRI would be based on a formula of inflation, minus a productivity factor, plus or minus exogenous changes (id.). The Plan does not allow NYNEX to petition the Department for any exceptions to the first pricing rule (id. at 4).

[45] The Company states that for the purpose of determining the percentage change in average usage associated with specified unlimited rate elements, it will use the average minutes of usage per line for the two calendar years immediately preceding the annual filing (Exh. NYNEX-1, at 8).

2. Second Pricing Rule

The second pricing rule prohibits NYNEX from proposing an increase in any rate element that would result in the AREI exceeding the REI, with limited exceptions (Exh. NYNEX-1, at 11). NYNEX states that, subject to Department approval, it might propose price increases that would result in the AREI exceeding the REI for: (1) obsolete services whose quantities are declining and have limited future market potential; (2) competitive necessity to charge higher rates; (3) service restructuring; or (4) addressing a legal concern (id. at 11-12).

NYNEX states that it could change the application of rate elements as long as such changes comply with all other pricing rules (id. at 13). For example, according to the Company, the statewide dial-tone rate could be reduced, increased, or eliminated for certain exchanges (id. at 13-14).

The second pricing rule also requires that the REI remain at 100.0 for certain basic residence service rate elements until the annual filing made by NYNEX in June 2001 (id. at 8).[46] This rate freeze would apply to the following basic residence service monthly rate elements:

Rate Element	Current Rate

[46] However, these rates could be subject to an increase if federal or state legislation increases telecommunications industry- or regulated utility-specific taxes (Exh. NYNEX-1, at 9-10). Also, the Company would have the ability to decrease these rate elements (Tr. 3, at 45).

1.	Residence dial-tone line	$	9.91
2.	Residence local messages (617/508 LATA)		
	per message (Zone 1)		0.01
	per minute (Zone 1)		0.016
3.	Residence local messages (413 LATA)		
	per message		0.01
	per minute (peak)		0.016
	per minute (off-peak)		0.008
4.	One-party unlimited residence service usage rate		6.94
5.	Two-party unlimited residence service usage rate		11.75
6.	Public emergency call receiving service rate[47]		11.75
7.	Measured 4E Standard service monthly rate[48]		13.35
8.	Measured 4E Low-use service rate		11.41
9.	Measured 4E local messages (Area A)		
	call establishment/per message		0.04
	connection charge/per minute		0.03

(*id.* at 8-9).

[47] Public emergency call receiving service provides an exchange line at designated locations, with a maximum of ten phones connected to that line. This service is designed for use in situations where a central location is not staffed by local officials on a 24-hour basis, and where it is desirable to have telephones at a number of different locations for receiving emergency calls (Exh. AG-295).

[48] Measured service - 4E (Four Element) consists of a flat monthly rate, local usage allowances and local usage charges, and is offered on a one-party residence basis in the New Bedford exchange only (M.D.P.U. - Mass. - No. 10, Part A, Section 5.1.8).

The $6.94 residence unlimited monthly usage rate, which is one component of the bundled rate for Metropolitan, Suburban, Circle Calling, Bay State East and Call Around 413 Plus calling plans, would also be frozen (id. at 9).

3. Third Pricing Rule

The Company proposed to increase prices only at the time of an annual filing (id. at 14). The annual filing would include increases and decreases in prices, show calculations of the new PRI, REI, API and AREI, and demonstrate that the price changes comply with all the pricing rules (id.).[49] The first such filing would be made on June 1, 1995, for effect August 15, 1995 (id.).

For the purpose of calculating the API and AREI, NYNEX would compare the proposed price with either the price for the rate element that was in effect in the prior year or, if the rate element was introduced subsequent to the prior year's annual filing, the initial effective rate for the rate element (id. at 15-16).

NYNEX stated that, to determine the overall weighted average percent change in prices, the Company would use as a study period the calendar year immediately preceding the date of the annual filing (id. at 16).

[49] The Company states that it would provide a comparison of the price contained in the annual filing with the price in effect prior to the annual filing for each rate element, regardless of whether a price change is proposed (Exh. NYNEX-1, at 14-15).

4. Fourth Pricing Rule

The fourth pricing rule applies to switched access services. The Company stated that switched access rates would be decreased in two steps, starting with the June 1, 1995 annual filing, to achieve the target rates established in D.P.U. 89-300 (id. at 12).

In addition, in each annual filing NYNEX would demonstrate that the average per minute differential between switched access rates and NYNEX's own toll rates would be no less than $0.011 (id.). However, the Company indicated that the differential could fall below $0.011 during the year, as a result of individual filings made between annual filings (id. at 12-13). at the next annual filing, the Company would have to set the differential equal to or more than the $0.011 minimum differential (id. at 13). The Department, on its own motion or upon petition by interested parties, could review the differential and order any change at the time of the next annual filing (id.).

5. Fifth Pricing Rule

The fifth pricing rule requires that the effective date of any price increases allowed under the Plan be subject to the Company meeting specified levels in a proposed Service Quality Index ("SQI") (Exh. NYNEX-4, at 6). The fifth pricing rule specifically mandates that NYNEX forego any price increases for the number of months that the SQI falls below specified levels (id.).

The Company currently reports service quality results on a monthly basis to the Department (Exh. NYNEX-7, at 4). The SQI would be a new measurement in the monthly reports currently provided to the Department (id. at 5). The SQI consists of twelve service items -- five items reported on a statewide basis, and seven items reported for each of the Company's three Strategic Business Units ("SBUs") (North/Northeast, South/Southeast, and Western/Central) (Exh. NYNEX-7, Att. B). The twelve service items are as follows:

Maintenance Service

1) Network Trouble Reports Per Hundred Lines
2) Percent of Troubles Cleared Within 24 Hours - Residence
3) Percent of Troubles Cleared Within 24 Hours - Business

Installation Service

4) Percent Appointments Missed Company Reasons - Total Customers
5) Percent Appointments Missed Company Reasons - Residence Customers
6) Percent Appointments Missed - Company Facilities
7) Installation Troubles per 100 Inward Orders

Service Response Items

8) Directory Assistance - Average Speed of Answer
9) Customer Service Bureau - Average Speed of Answer
10) Toll & Assist - Average Speed of Answer
11) Residence Service Level
12) Business Service Level

(id.)

A Target level and a Standard level of performance would be established for each of the twelve service items (Exh. NYNEX-7, at 6). Each month, the twelve-month rolling average for each of the twelve service items would be compared to the Target and Standard performance levels (id. at 7). Based on this comparison, points for each service item would be assigned and these points would sum to the SQI (id.).[50] A service item that meets the Target level would result in two points, a service item that achieves only Standard performance would result in one point, and failure to meet Standard performance would result in zero points (Exh. NYNEX-7, Att. B at 1). Based on the twelve performance items, the SQI would allow for a maximum of 52 points each month, consisting of the following: five statewide items (two points each item, for a maximum of ten points statewide); and seven items in each of the three SBUs (two points each item, for a maximum of 42 points for all three SBUs) (id. at 2). The Company proposes that there be no delay in allowed increases in rates, as long as the SQI totals 26 points or more in each of the twelve months preceding the annual filing (id.).

[50] The Company also proposes to exclude from the SQI evaluation period those months in which the SQI falls below the specified level because of events beyond the Company's control, such as severe conditions resulting from: "natural catastrophe; acts of sabotage; fires; severe flooding; hurricanes; strikes against entities other than NYNEX, its parent or affiliates; major plant or equipment damage done by third parties; and unusually severe weather" (Exh. NYNEX-7, at 7-8).

D. Streamlined Tariff Review

The Company states that, under the Plan, it would make tariff filings to introduce new services, or reduce prices of existing services, between annual filings (Exh. NYNEX-1, at 17-18). These filings would not include any price increases (other than those exceptions allowed in the second pricing rule described, supra), but would be subject to a "streamlined" tariff review procedure (id. at 18). The Company would not be required to provide cost support for its tariff filings, but only demonstrate that the filed tariffs comply with the pricing rules (id.).

Suspension of tariffs would be allowed only if the Company does not comply with the pricing rules, or for reasons related to privacy, public safety, or any conflict with the Department's regulations such as billing and collection rules applicable to residence customers (id. at 19).

The Department could undertake an investigation into a proposed tariff filing if claims of anticompetitive behavior are made, and the burden of proof would rest with the party making the claim (id. at 20). According to the Plan, a tariff filing could be judged anticompetitive only if the service is priced so that incremental revenues are less than the incremental costs of the service (id.). Also, the tariff could not be suspended unless the Company made a request to suspend during an investigation (id.).

E. Earnings Regulation

Under the Plan, NYNEX would not be subject to ROR regulation and would be exempt from challenges to, or review of, its earnings based on principles of ROR regulation (id. at 24). In addition, NYNEX would have discretion to adjust its depreciation rates, provided that the lives used to determine those rates would not be greater than the lives prescribed by the FCC (id. at 21-22).

F. Lifeline Discount

Within 30 days following approval of the Plan, the Company would increase the Lifeline discount by $2.50 per month, and the Company would not propose any decrease in the Lifeline discount until its annual filing in 2001, at which time the discount would become subject to the pricing rules of the Plan (id. at 21).

G. Term of the Plan

NYNEX proposes a minimum ten-year term for the Plan (id. at 10). NYNEX also proposes that it be allowed to petition the Department to modify any terms and conditions of the Plan (1) to reflect the impact of federal or state legislation enacted or court decisions issued subsequent to approval of the Plan; or (2) to seek a less structured form of regulation based upon changes in market conditions (id.).[51]

IV. THE ATTORNEY GENERAL'S PRICE CAP PLAN

In his direct case, the Attorney General, in addition to stating his criticisms of the Company's Plan, presented his own proposal for an alternative form of regulation for NYNEX's intrastate operations in Massachusetts (Exh. AG-796).[52] The Attorney General's Plan consists of four sections: (1) policy objectives; (2) categories of services and criteria for the classification of services into these categories; (3) proposed pricing flexibility, earnings sharing mechanism, price cap index, and a prohibition against cross-subsidization of competitive services with revenues from noncompetitive services; and (4) proposed implementation of the plan, determination of a price floor, cost allocation, and reporting requirements (id.).

A. Policy Objectives

The Attorney General's Plan includes the following six policy objectives for NYNEX in Massachusetts: (1) diversity in the supply of telecommunications services; (2) innovation in the

[51] NYNEX states that in any such proceeding, the burden would be on the Company to establish the basis for the modification (Exh. NYNEX-1, at 10-11).

[52] The Department has thoroughly considered the Attorney General's price cap proposal and in some cases has adopted aspects of his proposal as modifications to NYNEX's Plan. However, the focus of the Department's investigation is NYNEX's petition for alternative regulation. See Trustees of Clark Univ. v. Department of Pub. Utils., 372 Mass. 331, 334 (1977).

telecommunications industry; (3) universal service; (4) just and reasonable rates; (5) emergence of a competitive telecommunications environment; and (6) flexible regulatory treatment (id. at 1).

B. Classification of Services

Under the Attorney General's Plan, telecommunications services would be classified into one of three categories, or "baskets," based primarily on the degree of competition for the service: (1) basic noncompetitive services; (2) discretionary noncompetitive services; and (3) competitive services (id. at 9-10).

Basket 1, "basic noncompetitive services," would include services that are considered not subject to competition because they are expressly protected from competitive entry by regulation, legislation, or other government policy, or there is insufficient competition to obviate the need for regulation (id. at 10). Basket 1 would include basic local exchange services that include a monopoly access component, or such services deemed essential by the Department for the provision of public safety or the protection of privacy; all service installation or maintenance services not available from competitive sources; and all local usage (id.). Basket 1 would also include Open Network Architecture ("ONA") elements and any other noncompetitive services for which positive network externalities are present (id.).[53]

Basket 2, "discretionary noncompetitive services," generally would include basic local exchange services not appropriately classified in Basket 1 (id.). Basket 2 would be limited to services furnished exclusively to end users, and would include central office-based features like call waiting, call forwarding, Caller ID, and others, but would exclude unbundled "bottleneck" ONA elements furnished to other providers as distinguished from "final" services furnished to their ultimate end user (id.).

Basket 3, "competitive services," would include competitive services requiring the use of plant and/or other resources that are also used by the Company jointly or in common for purposes of producing and/or furnishing services classified in Baskets 1 or 2 (id.). Basket 3 would include the following: (a) all services involving the compilation, preparation, publication, and distribution of Yellow Pages; (b) all services involving the installation, maintenance, or repair of residential inside wire, or the installation, maintenance, or repair of residential customer premises equipment; (c) all Centrex services that have been previously determined by the Department to be subject to competition; (d) enhanced services; and (e) billing and

[53] The Attorney General defines a positive network externality as existing when the value or usefulness of the service to any one subscriber increases as the total number of subscribers to that service grows (Exh. AG-796, at 10).

collection services (id. at 10-11).

The Attorney General's Plan also includes "Stand Alone Test" criteria for evaluating petitions to classify a service in Basket 3 (id. at 11). Under the Stand Alone Test, a service would be classified in Basket 3 if the service could still be furnished by other providers even if NYNEX did not offer the service (id.). The Attorney General's Plan outlines administrative procedures to be followed for a petition for reclassification of a service (id. at 11-12).[54]

C. Pricing Rules

Under the Attorney General's Plan, rates for services in Baskets 1 and 2 would be subject to certain pricing rules while services in Basket 3 would not be subject to price regulation provided that rates for Basket 3 services exceed incremental cost (id. at 5).[55]

The proposed pricing rules for Baskets 1 and 2 are defined in part in reference to several indices: (1) price cap index; (2) competitive services price index; (3) maximum annual price

[54] Additionally, the Attorney General's Plan contains a provision that prohibits deregulation during the term of the plan of any service subject to the Department's regulatory jurisdiction and/or that forms part of the Company's intrastate revenue requirement (Exh. AG-796, at 12).

[55] The Attorney General's Plan also includes a prohibition against cross-subsidization of competitive services in Basket 3, with revenues generated from Baskets 1 and 2 services (Exh. AG-796, at 9).

increase; and (4) actual price index (id. at 2-4).

1. Indices

a. Price Cap Index

> The Price Cap Index ("PCI") initially would be set at 100 and would be computed annually according to the following formula:
>
> $$PCI_{new} = PCI_{old} * [1+(\triangle GDP\text{-}PI - X \pm Z + Q)]$$
>
> where PCI_{new} = Price Cap Index for current year.
> PCI_{old} = Calculated PCI for previous year.
> $\triangle GDP\text{-}PI$ = Percentage change in Gross Domestic Product Price Index.
> X = Productivity offset.
> Z = Exogenous cost changes.
> Q = Zero or less than zero, based on whether the Company meets minimum quality of service standards.

b. Competitive Services Price Index

> The Competitive Services Price Index ("CSPI") is a calculation of the annual and cumulative change in the price of all services included within Basket 3, exclusive of Yellow Pages revenue.

c. Maximum Annual Price Increase

> The Maximum Annual Price Increase ("MAPI") is equal to the lesser of the cumulative one-year change in the PCI or the cumulative one-year change in the CSPI.

d. Actual Price Index

> The Actual Price Index ("API") initially would be set at 100 and is the weighted average change in the prices of all of the Basket 1 and 2 services subject to the PCI.

(id.).

2. Application of Pricing Rules

For services in Basket 1, price changes would be made by applying the MAPI uniformly to each rate element in the basket, subject only to the requirement of rounding (id. at 5). For services in Basket 2, individual rate elements could be priced without limit, provided that the rates exceed the incremental cost, and provided that the rate levels would not cause the MAPI for Baskets 1 and 2 to be exceeded (id.). In addition, the API would be set by the Company at a level that is equal to or less than the lesser of the cumulative one-year change in the PCI or the cumulative one-year change in the CSPI (id. at 4).

The Company could propose changes or other modifications in rates for individual Basket 1 and 2 services, as well as propose new services, subject to the following limitations: (1) if any Basket 1 rate or tariff change affects more than one percent of the Company's customers or results in an annual revenue change in excess of $250,000, the Company shall propose offsetting changes in other rates and tariffs for Basket 1 services to assure effective revenue neutrality; (2) if any Basket 2 rate or tariff change affects more than one percent of the Company's customers or results in an annual revenue change in excess of $1,000,000, the Company shall propose offsetting changes in other rates and tariffs for Basket 2 services sufficient to assure that the aggregate level of revenue for all Basket 2 services shall not have increased;[56] (3) in determining whether a tariff revision

[56] For the purposes of (1) and (2), above, the Attorney General's Plan provides that "the determination of revenue (continued...)

would be subject to the requirements of (1) and (2), above, the number of affected customers and the magnitude of the revenue change shall be determined cumulatively with respect to all service and rate elements within the same type and class of service proposed for change within the same fiscal year used by the Company; (4) if the effective date of the rate change shall coincide with the next Annual Price Cap Index Adjustment Date (see Section IV.D, infra), the Company could propose as its offsetting rate change a modification in the API sufficient to achieve revenue neutrality; (5) if the Company proposes a new service or withdraws an existing service, the requirements of (1) and (2), above, would be based on a projection of anticipated cross-elastic interactions between the proposed new service and/or withdrawn existing service and its remaining existing services where the new service or withdrawn existing service would or may be a substitute for a remaining existing service (id. at 7-9).

D. Price Cap Implementation

Under the Attorney General's Plan, the Company would have to "elect" to be regulated under the plan and would notify the

[56] (...continued)
effect shall be made on the basis of the direct revenue change based upon the most currently available test year quantities, the effects of demand stimulation and repression for all services subject to price change, and the cost changes attributable to the projected demand response" (Exh. AG-796, at 7-8).

Department of this election not less than 90 business days prior to the beginning of the Company's next fiscal year (id. at 1-2). The plan would be in effect for three years and may be extended for additional three-year periods at the Company's election (id. at 2).[57] The date for commencement of the plan would be the first day of the next fiscal year subsequent to the 91st day following receipt by the Department of the Company's election, and the commencement date would become the "Annual Price Cap Index Adjustment Date" (id.). On the Annual Price Cap Index Adjustment Date the Company could adjust its rates according to the pricing rules described above (id. at 4).

The Attorney General's Plan also provides that 90 business days preceding each Annual Price Cap Index Adjustment Date, the Company shall file with the Department its "Annual Price Cap Index Filing," which shall set forth the new PCI, CSPI, MAPI, and API, any proposed exogenous cost adjustments, and any negative quality of service adjustment (id.). The Attorney General's Plan also outlines administrative procedures to be followed related to the Department's review of the Annual Price Cap Index Filing (id. at 4-5).

E. Earnings Regulation

[57] According to the Attorney General's Plan, the Company may withdraw its election within 15 business days following a final decision regarding initial rates, rate structure, and rate of return (Exh. AG-796, at 2).

Under the Attorney General's Plan, the Department would establish a Benchmark Rate of Return ("BROR") applicable to the Company (id. at 5).[58] The BROR in effect as of the date of election of price cap regulation by the Company would remain in effect for the first three years under price cap regulation (id. at 5-6). As part of its Annual Price Cap Index Filing, the Company would provide the Department with an Annual Report of Earnings prepared pursuant to Part 32 of the FCC's rules and subject to any modifications thereof that may have been adopted by the Department (id. at 6).

Based on the Annual Report of Earnings, if the Department determines that the ROR is in excess of 50 basis points above the BROR, the Company should share that excess on a 50/50 basis with ratepayers (id.). If the Department determines that the ROR is in excess of 500 basis points above the BROR, all earnings in excess of 500 basis points above the BROR should be credited to ratepayers (id.). If the Company's ROR for any two consecutive years decreases to below the BROR minus 325 basis points, then the Company may petition the Department to terminate the price cap regulation plan and revert to traditional rate base

[58] The Attorney General's Plan provides that in establishing the BROR, the Department shall explicitly recognize and consider the favorable reaction in the capital markets that can be expected to result from the expanded earnings opportunities that are afforded the Company operating under price cap regulation (Exh. AG-796, at 5).

regulation (id.). The Company may simultaneously petition for an emergency rate increase upon a showing that the earnings deficiency was sudden and unexpected (id. at 6-7). If the Company successfully petitions to revert to traditional rate base regulation, it may not elect to return to price cap regulation for a period of three years, unless the Department determines that reinstitution of price cap regulation is in the public interest (id. at 7).

F. Initial Rates

As part of the Attorney General's Plan, if the rates and tariffs, rate of return, or other matters relating to the revenue requirement, cost allocation, and rate design of the Company have not been subject to general review by the Department within one year preceding the effective date of the price cap regulation: (1) the Company may propose alternative initial rates; or (2) the Department shall on its own motion or on the motion by an interested third party initiate a proceeding for the purpose of setting initial rates for the Company (id. at 12-13).

G. Cost Allocation

The Attorney General's Plan also contains proposed cost allocation standards for the purpose of establishing a price floor for Basket 3 services (id. at 13).[59] In addition, these

[59] The cost allocation section of the Attorney General's Plan provides certain specific requirements for an incremental (continued...)

standards would apply where the provision of a service that has been deregulated involves the shared use of the public network infrastructure, or personnel other than corporate officers, and/or marketing, administrative, billing, or other resources of the Company that are used in the provision of Basket 1, 2, or 3 services and that are subject to above-the-line treatment for regulatory purposes (id.).

H. Other Provisions

The Attorney General's Plan also contains provisions and procedures related to reporting requirements, protection of customer proprietary network information and records, and the filing of tariffs and other measures to assure nondiscriminatory access by competitors to resources of the Company (id. at 14-15).

V. GENERAL ISSUES

A. Alternative Regulation for NYNEX

1. Positions of the Parties

a. NYNEX

The Company has proposed price regulation as an alternative to ROR regulation "in order to establish a regulatory framework with more appropriate incentives for the future" (Exh. NYNEX-8, at 3). According to the Company, price regulation "is a more appropriate regulatory framework than [ROR] regulation because it

[59] (...continued) cost study to establish a cost floor for Basket 3 services (Exh. AG-796, at 13).

fully protects consumer interests while providing a regulated firm the types of incentives found in a competitive marketplace" (id.).

NYNEX maintains that price cap regulation provides consumers with greater benefits than ROR regulation because: (1) price cap regulation better emulates a competitive market; (2) a reasonable price cap formula guarantees an overall reduction in the level of prices in real terms; and (3) price cap regulation shifts the risks and rewards of investments to the Company and its shareholders (NYNEX Brief, App. B at 1).

NYNEX asserts that "the objective of incentive regulation from an economic perspective is to emulate the outcome of competition in those markets where competition is not present" (id. at 19, citing Exh. NYNEX-3, at 2). NYNEX described the benefits of competition as just and reasonable prices, suitable service quality, efficient use of resources, technological progress, and implementation and marketing of new products and services (id.). According to the Company, incentive regulation achieves these same competitive benefits in a regulated environment (id.). NYNEX argues that the Plan is designed to provide the Company with economic incentives to operate more efficiently, to compete effectively, and to invest in the state's telecommunications infrastructure (id. at 21). According to NYNEX, these incentives are in "sharp contrast" to incentives under ROR regulation (id.).

NYNEX maintains that the primary reason for regulation is to prevent a firm from inefficiently raising its aggregate price, and that price cap regulation directly addresses this concern (id.). In addition, NYNEX argues that price cap regulation would reward efficiency gains beyond a fixed standard with higher profits, which, according to NYNEX, is similar to a competitive process (id. at 21-22). NYNEX argues that price regulation more closely aligns a firm's profitability to its ability to serve efficiently and become more responsive to the needs of the firm's customers (id. at 22). According to NYNEX, price regulation under the Plan will assure that the Company's rates will remain stable and predictable, with overall increases less than the rate of inflation (Exh. NYNEX-8, at 4).

NYNEX states that "it is becoming increasingly difficult to continue to sustain [policy goals] under a traditional rate-of-return regulatory framework," due to advancing technology and increased competition (id. at 6). The Company further argues that "the basic principle of [ROR] regulation is the commitment that a regulated company will have a reasonable opportunity to recover its prudently invested capital and expenses incurred in providing service to customers," and that this regulatory commitment cannot be sustained, given the changes in the industry (NYNEX Brief at 23, citing Exh. NYNEX-8, at 6-7). NYNEX asserts that earnings flexibility is essential (1) to meet customer demands and keep pace with new and converging technologies, and (2) to support the investment necessary for network development in a changing industry (id.).

NYNEX argues that the rapid change in the telecommunications industry and the corresponding substantial risks in telecommunications investment is a primary economic reason for adopting price cap regulation (id. at 19, citing Exh. NYNEX-3, at 6). NYNEX maintains that price regulation shifts investment risk to shareholders, and that this shift more closely resembles the competitive process and is superior to "after-the-fact, prudence of investment reviews, potential disallowances and inadequate level of capital recovery, which are characteristic of [ROR] regulation" (id. at 22, citing Exh. NYNEX-8, at 5, and D.P.U. 86-36-A). NYNEX argues that price cap regulation forces the firm to justify investment according to the profits it can earn on that investment, thus eliminating the theoretical Averch-Johnson incentive [60] (Exh. NYNEX-3, at 3-4).

[60] Dr. Taylor describes the Averch-Johnson incentive as follows: "When the allowed rate of return is higher than the cost of capital, the Averch-Johnson incentive means that the firm will employ too much capital, e.g., expand into otherwise unprofitable markets" (Exh. NYNEX-3, at 3 n.1, citing H. Averch and L.L. Johnson, Behavior of the Firm Under Regulatory Constraint, 52 Am. Econ. Rev. 1053-1069 (1962). NYNEX asserts that the "cost plus" approach of ROR regulation provides inadequate incentives for the regulated firm to minimize costs, invest in cost-reducing or demand-enhancing technologies, or to
(continued...)

NYNEX also argues that the Company's direct and indirect regulatory costs would be reduced under price cap regulation because it is "far easier to measure and track prices than profits," and that the administrative costs of ROR regulation to the Company, the Department, and the intervenors cannot be ignored (NYNEX Brief at 23).

With regard to the argument, presented by several intervenors, that a certain level of competition must be achieved as a prerequisite for incentive regulation, NYNEX maintains that incentive regulation, even without competition, is appropriate because ROR regulation "distorts incentives of the regulated firm to reduce its costs and expand demand" (id. at 24, citing Exh. NYNEX-3, at 5). NYNEX argues that the Plan takes the place of the competitive process, and, therefore, price cap regulation is not dependent on the presence or degree of competition or the establishment of a specific market structure (id. at 25-26).

NYNEX maintains that in markets where there is sufficient competition such that a firm cannot increase profits by raising prices, no regulation is necessary; however, according to the Company, in markets where a firm retains the ability to control prices, incentive regulation protects customers from price increases (id. at 25).

[60] (...continued)
market aggressively (NYNEX Brief at 21, citing Exh. NYNEX-3, at 3, 38).

In addition, according to the Company, "the mere possibility of competitive entry into previously monopoly markets makes change to incentive regulation imperative" because, depending upon the competitive skills of the new entrants, the regulated firm may be unable to recover its costs (id. at 24-25, citing Exh. NYNEX-3, at 5). Dr. Taylor noted that successful competitors must be allowed to succeed and inefficient firms allowed to fail, if society is to benefit (id. at 25, citing Exh. NYNEX-3, at 5). NYNEX asserts that this philosophy should also apply to regulated firms by using incentive regulation (id.). NYNEX maintains that incentive regulation induces a firm to renounce its right to recover its costs in return for an opportunity to earn greater than an average return on its investment (id. at 25).

NYNEX maintains that it should be offered the option to reject any modified alternative regulation plan and return to the transition process because any "material changes to the Plan could alter the balance of risks, incentives and safeguards included in the [Company's] proposal" (id., App. B at 7).

b. Attorney General

The Attorney General argues that, provided a price cap plan is appropriately designed, "there is good reason to believe that consumers would receive greater benefits than under continued rate-of-return regulation" (Attorney General Brief, Part I, at 14). The Attorney General asserts that the goal of economic regulation of public utilities is to simulate the competitive result, and that price cap regulation can create an incentive for competitive behavior by NYNEX by "weaken[ing] the direct linkage between an individual firm's costs and revenues that exist (sic) under the `cost plus' philosophy of rate of return regulation" (id. at 15). Therefore, the Attorney General argues that the Department should adopt a "well designed price cap plan" and not maintain ROR regulation for NYNEX (id. at 16).

The Attorney General asserts that the price cap plan adopted in California is an example of a well-designed plan and, according to the Attorney General, that plan has been providing benefits over the last three years with no substantial earnings erosion (id. at 15, citing Tr. 22, at 85-86 and Tr. 28, at 19, 55). The Attorney General maintains that his proposal in this case is very similar to the California price cap (id. at 15).

The Attorney General states that NYNEX should be given the option of maintaining ROR regulation if the Department adopts an alternative form of regulation that differs from that proposed by the Company (id. at 17).

c. AT&T

AT&T argues that it is not opposed to price cap regulation for NYNEX, as long as (1) sufficient safeguards against anticompetitive behavior are in place, and (2) the price cap is structured to promote the development of effective competition and to prevent the subsidization of competitive services from noncompetitive services (AT&T Brief, Att. B at 2).

AT&T maintains that NYNEX's theoretical justification for price cap regulation exaggerates the potential benefits of price cap regulation and the deficiencies of ROR regulation (AT&T Reply Brief at 8). AT&T also argues that NYNEX does not consider the extent to which the alleged benefits of price cap regulation would be achieved without a change in the form of regulation (id.).

AT&T notes that the Department, in D.P.U. 1731, determined that, in light of the Company's market power, the appropriate form of regulation for NYNEX was ROR regulation (AT&T Brief at 22, citing IntraLATA Competition, D.P.U. 1731, at 36-38 (1985)). However, AT&T further notes that in the current proceeding each of the witnesses acknowledged that an alternative form of regulation might also be adequate to constrain NYNEX's market power (id.). Therefore, according to AT&T, the dispute in this case is not about whether price cap regulation is inconsistent with achievement of the Department's telecommunications policy goals, it is about the sufficiency of NYNEX's Plan in achieving those goals (id.).

In addition, AT&T maintains that the record in this case confirms that the market power NYNEX had in the intraLATA market at the time that the Department decided D.P.U. 1731 remains today (id. at 29). AT&T argues that NYNEX has offered no evidence to justify the Department's abandoning the regulatory rules that were established for NYNEX in D.P.U. 1731 (id. at 29-30).[61]

AT&T maintains that the enhancement of competition should be the touchstone of the Department's decision on NYNEX's petition (id. at 14). AT&T notes that the economic testimony in this proceeding is unanimous that (1) competition is superior to regulation in the promotion of economic efficiency and fairness, (2) public utility regulation should have as a principal goal the emulation of competitive markets and incentives, and (3) the degree of regulation should depend on the degree of competition (id. at 20-21).[62] AT&T maintains that the adoption of price cap regulation for NYNEX should occur after, or simultaneously with, "implementation of those measures that [the Department] determines to be necessary and appropriate to advance its oft-stated goal of ensuring the development of effective

[61] AT&T states that the Department is not required to adhere forever to its prior decisions, but argues that the Department must demonstrate a reasoned consistency in its decisions, and that its decisions must be supported by the record evidence and must not be arbitrary or capricious (AT&T Brief at 29, citing Boston Gas Co. v. Department of Pub. Utils., 367 Mass. 92, 104 (1975)).

[62] AT&T asserts that the Department, in D.P.U. 1731, found that "the degree of regulation that should apply to a particular market should reflect the degree of competition present" (AT&T Brief at 16, citing D.P.U. 1731, at 45).

competition for all telecommunications markets in Massachusetts" (id. at 6).[63]

AT&T argues that NYNEX's treatment of the competition issue in this docket is self-contradictory (id. at 24). AT&T asserts that although NYNEX explicitly disavows any relationship between the level of competition in Massachusetts and the need for alternative regulation, it is clear that "NYNEX's anticipation, or fear, of competition ... is one of, if not the, principal motivating factors behind its proposed [Plan]" (id. at 25).

AT&T maintains that NYNEX should be given the option of maintaining ROR regulation if the Department adopts an alternative form of regulation that differs from that proposed by the Company (id., App. B at 3).

d. MCI

MCI argues that the Department should modify the form of regulation for NYNEX commensurate with (1) the degree of competition that NYNEX faces, and (2) the extent to which safeguards are in place to protect ratepayers and competitors (MCI Brief at 35-36).

MCI maintains that there is not generally a

[63] AT&T notes that the Department is considering market structure and competition issues (see Local Competition , D.P.U. 94-185 (Vote to Open Investigation) (1995)), and AT&T argues that the Department should defer adoption of alternative regulation for NYNEX pending the outcome of the new investigation (AT&T Reply Brief at 2-3).

"consumer-oriented rationale for price cap regulation. Rather the justification is that price cap regulation affords consumer protection by setting maximum rates for the monopolist" (id. at 35). MCI asserts that the benefit consumers receive from price cap regulation is meaningless if the capped rates are set at levels that an unregulated monopolist would charge (id.).

MCI argues that the Department should establish the regulatory framework for effective competition prior to allowing NYNEX pricing and earnings flexibility (id. at 1). MCI asserts that "the only proper justification for relaxing pricing and earnings constraints on [NYNEX] is the presence of competitive pressure" (id. at 3). In addition, MCI contends that delaying implementation of alternative regulation for NYNEX pending resolution of competition issues will give NYNEX the incentive to cooperate in that resolution; otherwise, NYNEX will have an incentive to delay the implementation of a competitive market framework (id. at 4-5).

MCI states that while it does not support implementation of any alternative regulation for NYNEX until the Department establishes a framework for effective competition, MCI considers the Attorney General's proposal in this case "far superior" to the Company's (id. at 17). MCI also argues that NYNEX should not have the option of maintaining ROR regulation if the Department adopts price cap regulation with modifications to NYNEX's original proposal (id. at 37).

e. NECTA

NECTA argues that NYNEX bears a heavy burden of demonstrating that existing regulation does not achieve the statutory obligations and ratemaking goals of the Department, and that NYNEX has failed to make such a demonstration (NECTA Brief at 6-7, 28). NECTA asserts that even if NYNEX had made such a demonstration, it would also have to prove that its Plan is lawful and a better method of achieving the statutory obligations and ratemaking goals of the Department (id. at 7).

In addition, NECTA maintains that "price regulation in any form is premature due to the lack of any real intraLATA competition" (id. at 61). NECTA also asserts that price regulation for NYNEX without the opening of a "truly competitive marketplace, would doom the prospects for the emergence of local competition" (id. at 62).

NECTA argues that NYNEX has failed to demonstrate that sufficient competition exists to warrant departure from ROR regulation (NECTA Reply Brief at 6). NECTA argues that "only existing competition of a significant magnitude with respect to all intraLATA services would justify approval and implementation of the NYNEX Plan on a regulatory policy basis" (emphasis in the original) (id. at 7). NECTA maintains that the Department has consistently found that the pricing flexibility sought by NYNEX in this case can be justified only in the presence of "actual, level playing field" competition (id., citing NET, D.P.U. 84-275/276/277 (1985); IntraLATA Competition, D.P.U. 1731 (1985)).[64]

NECTA contends that existing regulation of NYNEX has (1) allowed the Company to maintain its financial integrity and attract capital; (2) given NYNEX substantial pricing flexibility; and (3) allowed the Department to enforce quality of service standards, encourage network investment, align the Company's rates for services with their costs, suspend and investigate proposed tariffs, and assess the impact of price changes on universal service and the emergence of competition (NECTA Brief at 7-8, 16-19).

NECTA asserts that "everything NYNEX claims to need more of (incentives to invest, pricing flexibility) is fully provided for under existing regulation" (id. at 8). NECTA argues that while the Company's Plan "claims to offer the perceived benefits of [deregulation]," deregulation for the sake of deregulation would produce disastrous results (id. at 9).

NECTA maintains that the principal purpose of the Plan for NYNEX is (1) to "advance the Company's anticompetitive objectives," and (2) "to build a broadband video network

[64] NECTA also asserts that the Department's recently opened local competition docket does not justify approval of the Plan (NECTA Reply Brief at 8).

subsidized by captive telephone ratepayers" (id. at 51, 57). NECTA argues that it is "especially incumbent upon the Department to consider whether existing regulation or price regulation best enables it to protect telephone consumers" of monopoly services from bearing the costs of the Company's broadband plans (id. at 53).

NECTA argues that if any price regulation plan is accepted by the Department, the Attorney General's proposal should be adopted, and implementation should be phased to allow for (1) changes in market structure, (2) establishment of reasonable starting rates, and (3) action by other state and federal policy makers affecting Department policy (id. at 97-98).

f. FEA

FEA "recognize[s] that the Department may wish to relax regulation of [NYNEX] somewhat ... [and] if so, FEA recommends a combined price cap earnings sharing procedure, with a thorough review of the Company's earnings to provide an effective starting point" (FEA Brief at 24). FEA maintains that it is not opposed "in principle" to adoption of an alternative form of regulation for NYNEX, but argues that the Department should defer significant change in the regulation of NYNEX until measures to promote effective competition and to protect consumers are in place (FEA Reply Brief at 2, 9). FEA argues that any price cap plan must protect ratepayers and interconnected competitors from practices that exploit NYNEX's market power (id. at 10).

FEA maintains that the Department should not consider alternative regulation for NYNEX prior to implementation of measures necessary to advance the development of effective competition in Massachusetts (id.).

g. NEPCC

NEPCC opposes "any dilution of traditional rate-of-return regulation for [NYNEX]," because, according to NEPCC, the Department could not find that the factors that led to the imposition of ROR regulation on NYNEX in D.P.U. 1731 do not currently exist (NEPCC Brief at 2). NEPCC maintains that the Department "cannot, in the guise of an `alternative regulatory plan,' give NYNEX the opportunity to engage in ... anticompetitive conduct behind a facade of reduced regulatory oversight" (id.).

In addition, NEPCC argues that a prime goal of the Department in this case must be to preserve the pro-competition goals of the Department (id. at 4). NEPCC states that, whatever form of regulation is in place for NYNEX, the Department should maintain a vehicle for eliminating the coin class imbalance between the rates NYNEX charges itself for pay-telephone service and the rates NYNEX charges pay-telephone service providers (id. at 3-4).

h. NELF

NELF notes that "virtually every party ... believes the Department legally can and, as a matter of sound regulatory policy, should move away from traditional rate of return regulation of NYNEX," and that all parties also accept that the emulation of competitive market incentives and outcomes where competition is lacking is a principal goal of regulation (NELF Reply Brief at 1). NELF further notes that there is general agreement that NYNEX should retain the option of continuing ROR regulation (id.).

2. Analysis and Findings

a. Background

Traditionally, utilities have been viewed as natural monopolies, and utility rate regulation has been employed to control against the negative effects of monopoly. See Weld v. Gas & Elec. Light Comm'rs , 197 Mass. 556, 558 (1908). These effects are not present in a competitive market so, as many of the parties to this case noted, the principal goal of utility rate regulation has been simulation of the results of a competitive market (see NYNEX Brief at 19; Attorney General Brief at 15; AT&T Brief at 20-21; and NELF Reply Brief at 1).

While simulation of the results of a competitive market is a principal goal of regulation, the Department has previously found that actual competitive telecommunications markets are preferable to regulation as a surrogate for competition. See D.P.U. 1731, at 25 (1985). The Department has long endorsed competitive markets over regulation as the best way to achieve its policy goals for telecommunications, because competitive markets promote economic efficiency, technological innovations, and a greater sensitivity to customer demands. Id.

Since 1985, the Department has consistently promoted the development of competition in all telecommunications markets in Massachusetts. See NET, D.P.U. 86-124-D (1986); NET, D.P.U. 89-300 (1990); NET, D.P.U. 91-30 (1991); Collocation, D.P.U. 90-206/91-66 (1991) and D.P.U. 90-206-A/91-66-A (1991) and D.P.U. 90-206-B/91-66-B (1993); AT&T, D.P.U. 91-79 (1992); NET, D.P.U. 92-100 (1992); Common Carrier Entry Deregulation, D.P.U. 93-98 (1994); and NET, D.P.U. 93-125 (1994). However, some carriers still have market power[65] in certain market segments, and the Department uses a variety of methods to regulate the rates of these dominant carriers and/or services. For example, virtually all of NYNEX's rates have been regulated according to traditional ROR regulation, AT&T's Basic MTS[66] rates

[65] The Department has previously stated that a firm with market power has the ability to raise the price of its product or service, and to sustain this price increase over a period of time, without losing so many sales that the price increase is not profitable. D.P.U. 91-79, at 31 n.19.

[66] AT&T's Basic MTS is defined as service provided to customers whose total monthly bills for intrastate, interstate, and international MTS calling are $5.00 or less. D.P.U. 91-79, at 12 n.11.

are regulated according to a weighted-average price cap, and alternative operator service companies' operator service rates must be cost-justified, or, in the alternative, must be equal to or less than the rates of AT&T or NYNEX. See D.P.U. 91-79; International Telecharge, Inc., D.P.U. 87-72/88-72 (1988).

b. NYNEX Petition

NYNEX has petitioned in this case to replace ROR regulation with price cap regulation. As we found earlier in this proceeding, there is no statutory impediment to a departure from ROR regulation, and the Department can adopt price cap regulation as a substitute for ROR regulation. See February 2, 1995 Interlocutory Order at 61-62. NECTA has suggested in this case that the Company has the burden to demonstrate that existing ROR regulation fails to meet the Department's existing policy goals and statutory mandate. The argument is both illogical, and incorrect as a matter of law. If the Department finds that an alternative form of regulation is an improvement over current regulation, it may allow, or even direct, the Company to replace the current system with the alternative, even though both systems may ultimately meet statutory obligations. See Id.; D.P.U. 91-79 (Department allowed a price cap for AT&T, without finding that ROR regulation was not achieving statutory requirements). Therefore, we find that the Company has no such burden.

The Department must decide whether (1) price cap regulation for NYNEX will promote the Department's telecommunications policy goals[67] more effectively than ROR regulation, [68] (2) price cap regulation for NYNEX requires achievement of a specified level of competition or market structure, and (3) NYNEX should have the option to accept the price cap plan described in this Order or to maintain the regulatory status quo.

i. Price Cap Regulation v. ROR Regulation

While most of the parties agree that a well-designed price cap form of regulation is preferable to ROR regulation, there is significant disagreement on the specific components of a price cap form of regulation for NYNEX and the necessity of first achieving a certain level of competition in the relevant markets and/or conducting a full rate case review. As explained, infra, we find that a well-designed price cap is preferable to ROR regulation for NYNEX and that approval of price cap regulation for NYNEX is consistent with, and will not inhibit, the development of competitive markets. It should be made clear, however, that although we view price cap regulation as superior to ROR regulation, we recognize that no form of rate regulation is superior to actual competitive markets, where they exist or

[67] The goals are: economic efficiency; fairness; earnings stability; simplicity; continuity; and universal service. D.P.U. 89-300, at 11-12 (citations omitted).

[68] The Department also determines in various other sections of this Order whether the price cap approved for NYNEX is consistent with the Department's statutory mandate.

can be achieved, in maximizing societal benefits.

In judging whether price cap regulation is superior to ROR regulation, we must first determine whether price cap regulation promotes economic efficiency better than ROR regulation. We agree with Dr. Taylor's description of the two types of economic efficiency: (1) technical efficiency and (2) allocative efficiency. He defined technical efficiency as the measurement of the value of resources expended to produce goods and services, and allocative efficiency as the measurement of the deviation of prices from incremental costs. [69]

Generally accepted economic theory indicates that an unconstrained monopolist will not behave in a way that promotes economic efficiency because the monopolist will price its services at a supra-competitive level in order to maximize its profits. Therefore, ROR regulation, which limits the revenues of a regulated company to recovery of its historic or embedded costs, has been used by the Department and most other utility regulators for many years. Several of the witnesses in this case testified that ROR regulation limits a firm's revenues to recovery of costs, and therefore that the firm has little or no incentive to minimize its costs. We agree and further note that

[69] Generally speaking, in ROR regulation the establishment of a revenue requirement is the traditional regulatory method to promote technical efficiency, and devising the proper rate structure to achieve that revenue requirement determines the level of allocative efficiency.

while the firm's profits may be kept to a reasonable level under ROR regulation, efficiency and its benefits to customers may not be attained fully because the firm's costs and investment are likely to be greater than they would have been in a competitive market.

We also agree with several witnesses in this case that well-designed price cap regulation prevents monopoly pricing through the use of an overall cap on a firm's rates. Application of a price cap formula to a firm's aggregate rates assures that the firm's earnings remain level if the firm achieves average productivity growth.[70] Under a well-designed price cap, if a firm earns a return higher than that which would be set under ROR regulation, those earnings would arise only from increased productivity gains. Such earnings would not be derived from the firm's position as a monopolist because the firm is not free to raise its prices apart from allowed adjustments under the price cap formula. Allowing the regulated monopoly to increase its

[70] This assumes that the firm is not receiving monopoly rent at implementation of the price cap. To prevent that from happening, the Department has conducted a review of NYNEX's earnings in this investigation (see Section VII, infra). As long as NYNEX is not receiving monopoly rent at the start of the plan, i.e., its starting rates are just and reasonable, the price cap formula will ensure that above-average earnings will arise only from extraordinary success in increasing productivity, and not from exercising market power. Moreover, a well-designed price cap anticipates sharing some of this productivity gain with consumers. See following text and Section VI.A.2, infra.

earnings due to above-average gains in productivity responds to the competitive outcome in that a competitive market rewards a firm that achieves above-average productivity growth with higher earnings. Therefore, under a price cap, so-called "excess" earnings are not monopoly rent.

We find that well-designed price cap regulation should promote technical efficiency because the firm has an incentive to reduce its costs and expand demand for its products where this will improve its earnings. [71] A firm is motivated by the desire to increase its profits, and, under a price cap, if its productivity exceeds the industry average, it will retain earnings beyond what the productivity offset captures for ratepayers. Recognizing that the profit incentive is the best motivating force for the behavior of firms, the adoption of price cap regulation would thus create an improved incentive for the firm to lower costs.

Because price cap regulation provides stronger and clearer motivation to pursue economic efficiency, the average annual productivity of the industry should be higher under price cap regulation than it is under ROR regulation. Resources expended

[71] We recognize that because of regulatory lag under ROR regulation, a utility has some incentive between rate cases to improve its earnings through cost reductions or increased demand. However, we believe that this incentive may be somewhat uncertain because no utility can rely on or predict regulatory lag.

to produce telephone service thus should be lower under price cap regulation, and, consequently, the overall level of rates consumers pay for telephone service should be lower, even as firms earn profits that may exceed those allowed under traditional ROR regulation. [72] This relationship is the core of the rationale for the price cap approach. If we did not believe this to be true, e.g., that customers will be better off even as firms' owners are better off, there would be little reason for us to adopt price cap regulation over ROR regulation. Based on the record in this case, we find that customers likely will benefit from a shift to price cap regulation and note that this is the primary reason for our finding that price cap regulation for NYNEX is more appropriate than ROR regulation.

We note that regulators traditionally have not attempted to achieve allocative efficiency in pricing telephone service, choosing instead to control the pricing of telephone service to serve other ends. It has been claimed that the economic benefits of allocative efficiency were purposefully sacrificed to achieve certain social goals, such as universal service, by pricing services on a social basis and not a cost basis. Partly in

[72] This is not to say that every rate will be lower at all points in time. For example, if prices for a firm with pricing flexibility are not currently set at a point where they maximize allocative efficiency, rates for some services will either increase or decrease more slowly than rates for other services, even though the aggregate resources devoted to telephone service should be lower.

recognition of its diminishing ability to use prices to achieve social goals, and partly in order to promote the economic benefits of pricing that more accurately reflected costs, the Department undertook a process of rebalancing NYNEX's rates in D.P.U. 89-300 and subsequent rate structure transition filings to make those rates more cost-based. For purposes of the current investigation, the extent to which allocative efficiency is further achieved is primarily a function of the pricing rules adopted by the Department. Also, the extent to which the Department's other telecommunications policy goals are achieved under price cap regulation is also a function of the pricing rules. Those goals will be described in the sections of this Order dealing with the pricing rules.

ii. Competitive Requirements for Price Cap Regulation

Some of the parties in this proceeding have argued that, prior to implementing alternative regulation for NYNEX, it is necessary to (1) achieve a specified level of competition, and/or (2) put in place the structural components necessary to achieve effective competition. We disagree with these parties regarding this suggested interdependence of competition and price cap regulation.

As noted, supra, most parties agree with the notion that the goal of regulation is to simulate the competitive outcome. Therefore, if effective competition exists, no rate regulation whatsoever (ROR regulation, price caps, etc.) would be needed. In a competitive market, competition itself will lead to the efficient outcome. We reemphasize that price cap regulation is not deregulation, it is merely another way for regulators to control the rates charged by a firm. Price cap regulation is also not necessarily a lesser degree of regulation, as alleged by AT&T and others.[73] Rather, price cap regulation replaces company-specific, test year cost-based control of a firm's rates with an index representing the expected changes in costs for the average firm in the industry. In both cases, the rates are being controlled by regulation. Therefore, we find that price cap regulation is neither appropriate for a fully competitive market, nor is its effectiveness dependent upon the presence of a specific level of competition.

As recalled by certain parties, the Department, in D.P.U. 1731, found that ROR regulation was appropriate for NYNEX, given its market power, and that the degree of regulation should be dependent on the level of competition. However, the parties misapply the Department's finding in that case to the question of whether evidence of effective competition is necessary to grant the relief requested by NYNEX in this proceeding. In

[73] It is true that well-designed price cap regulation involves less direct government oversight of the utility's operations, but the degree of regulation should not be measured in terms of direct government oversight.

D.P.U. 1731, the Department's finding on the level or the degree of regulation related to whether a carrier should be classified as "dominant" or "nondominant." D.P.U. 1731, at 56. The Department's determination that NYNEX should be subject to ROR regulation because the Company was a dominant carrier was not a choice between methods of rate regulation, but a choice between regulatory or market-based control of rates. [74] In fact, as noted, supra, the Department has in two situations allowed other dominant carriers to substitute another form of regulation for ROR: (1) operator service companies are allowed to set their rates at or below the rates of NYNEX or AT&T; and (2) the Department approved a weighted-average price cap for AT&T's low-volume MTS service. In D.P.U. 1731, the Department chose ROR regulation as the form of regulation for NYNEX because, at the time, there was no generally recognized alternative form of regulation for dominant carriers.

If NYNEX were requesting market-based pricing in the instant petition, it would certainly be required to make a showing of effective competition in order for the Department to consider granting such relief. [75] As noted, because NYNEX is merely

[74] Similarly, contrary to NECTA's assertions, the Department's determination that market-based control of rates for dominant carriers' sufficiently competitive services is reasonable was not the result of choosing between methods of rate regulation.

(continued...)

requesting a change in the methodology for regulatory control of its rates, we have found that no threshold showing of a particular level of competition is necessary, and the rules established in D.P.U. 1731 are not being changed.

Although we have found that implementation of price cap regulation is not dependent on any level of competition, we note that price cap regulation should be particularly well-suited to an increasingly competitive market characterized by a greater level of investment risk and technological convergence, because a well-designed price cap plan insulates ratepayers from investment risk and subsidization of new ventures. Moreover, we do not believe the price cap plan we adopt in this Order will thwart the development of competition, in that it contains appropriate competitive safeguards (see Section VI.C.1.b.ii). [76] In addition, contrary to NECTA's claims, it is not necessary that this change in regulation for NYNEX be delayed until certain (unspecified) actions by state and federal policymakers are taken.

[75] (...continued)

[75] For example, such a showing of competition would be necessary if NYNEX were requesting that services be declared sufficiently competitive, as AT&T did in D.P.U. 91-79. NYNEX has made no such request in this proceeding.

[76] NEPCC's concern regarding the "coin class imbalance," is an issue related to the relationship of NYNEX's retail and wholesale rates. The Department has established in this Order (see Section VI.C.1.b.ii) a price floor that is intended in part to address concerns about retail/wholesale rate relationships.

iii. Option to Accept the Department's Price Cap Plan

As described in the following sections, the Department has made a number of changes to the Company's Plan in this Order. The price cap plan approved in this Order represents an improvement over the current mode of regulation in terms of benefits for ratepayers and NYNEX. Therefore, we find that it would not be appropriate to allow NYNEX to choose whether to continue the status quo or accept the plan described herein.[77]

[77] Some parties, including the Company, have argued that the Department should give NYNEX the option of accepting or rejecting the price cap that the Department approves. No party contends that we are without authority to order the Company to implement this new form of regulation. Indeed, G.L. c. 159 gives the Department broad authority to determine the appropriate form of regulation for NYNEX, and it necessarily follows that if the Department has authority to approve a new form of regulation for common carriers, it also has the authority to compel implementation of that new regulatory scheme, assuming that the new regulatory scheme is consistent with the Department's statutory mandate and lies within constitutional limitations. See G.L. c. 159, § 12 ("The department shall, so far as may be necessary for the purpose of carrying out the provisions of law relative thereto, have general supervision and regulation of, and jurisdiction and control over ... [t]he transmission of intelligence within the commonwealth by electricity, by means of telephone lines ....") (emphasis added); Holyoke St. Ry. Co. v. Department of Pub. Utils., 347 Mass. 440, 450 (1964) (the Department can "exercise a wide range of discretion in appraising the public interest and in adopting reasonable policies, principles, and standards for its guidance"); February 2, 1995 Interlocutory Order at 61-62. The Legislature, acting under the Constitution, is the primary judge of what is "necessary" for the purpose of fulfilling the Department's statutory mandate, but has delegated implementation of its judgment to the Department, acting under statute.

The Department finds the proposed price cap plan as modified to be superior to the Company's proposal or traditional ROR regulation in serving the public interest. Allowing a less beneficial regulatory method to be chosen by the Company might well be contrary to maximizing the public interest.

On a going-forward basis, the Company or any other petitioner may request that the Department modify any of the terms or conditions of the price cap plan (1) to reflect the impact of federal or state legislation or court decisions enacted or issued subsequent to the Department's approval of the plan, or (2) to seek a less structured form of regulation or deregulation of NYNEX's operations based upon changes in market conditions. The burden of proving that a change to the price cap plan is necessary under one or both of the above conditions will be on the petitioning party. We stress that the Department will not lightly consider any request under the conditions listed above to change the terms of the price cap plan described in this Order. In order for the incentives in a price cap plan to work most effectively, there must be a high degree of certainty that the plan will not be tampered with, or recontracted, save for compelling reasons (see Tr. 2, at 180-182; Tr. 8, at 89-90).

B. Transitional Rate-Restructuring

With its April 14, 1994 petition for approval of the Plan, NYNEX filed a Motion to Defer the filing of its 1994 transitional rate design pending the Department's decision on the Company's Plan. In the June 14, 1994 Interlocutory Order, the Department found that it would be inefficient to continue with the transitional rate process while reviewing the Plan and granted the Company's Motion to Defer the filing of its 1994 transitional rate filing. June 14, 1994 Interlocutory Order at 36. Also, as part of the Plan, NYNEX proposed that the Company not be required to make annual transition filings to achieve the target rates approved in D.P.U. 89-300 (Exh. NYNEX-1, at 23-24).

1. Positions of the Parties

a. NYNEX

NYNEX maintains that the Department should accept its proposal to discontinue the transitional rate-restructuring if the Plan is adopted (NYNEX Brief, App. B at 6). NYNEX argues that adopting the Plan would shorten the transition process and better meet the Department's goals than delaying implementation of the Plan until completion of the transition process (id.). NYNEX asserts that: (1) the Department has moved far toward achieving the target rates; (2) the Plan creates conditions that will continue the movement of usage and toll rates toward the target levels; and (3) the residence exchange rate cap serves legitimate interests, including universal service (id. at 121).

NYNEX asserts that it has presented substantial evidence to support a departure from the transitional process "in light of the changing telecommunications environment and the need to provide proper incentives for the Company to meet customer demands and compete effectively in the marketplace" (id. at 275). NYNEX further argues that, to a large extent, the transition process has accomplished its overall objective of realigning the Company's rates, and that the Company will continue to achieve the goals of the transition process, while "creating customer benefits" through other components of the Plan (id.).

NYNEX notes that the primary target rates that have not yet been achieved are: (1) residence exchange; (2) local usage and toll in the 617/508 LATA; and (3) switched access (id. at 117-118). NYNEX argues that, under the Plan, the Company proposes to reduce switched access prices to target levels, and that rather than adversely affecting competition, the reduction in switched access rates will create "a dynamic situation" by establishing an incentive for the Company to reduce its own toll rates in response to the access rate reductions (id. at 118-119).

With regard to switched access, NYNEX argues that lowering the rate for switched access only will increase the margin between retail (toll) and wholesale (access) service rates, and thus movement of retail rates toward target rates will continue under the Plan (id. at 118). Regarding residential exchange rates, NYNEX argues, although the rates will remain below the target rate, competitive entry is still possible at the capped (current) rates (id. at 119, citing Tr. 27, at 122). In addition, the Company notes that in the future, the Company could be requested to unbundle or resell the service and, according to NYNEX, these steps could create competitive opportunities (id. at 119, citing Tr. 27, at 127-128). NYNEX argues that, because of the progress that has already been made, failure to achieve target rates in the time period outlined in the Department's rate-restructuring decisions does not harm future competition, as some intervenors maintain (id. at 119-120).

In response to AT&T's assertion that the Department is legally prohibited in this case from adopting the Plan because the evidence does not support termination of the transition process, NYNEX argues: (1) the Department has the broad discretion to examine and initiate changes in regulatory policy and to determine that a new regulatory framework may better serve its goals;[78] (2) the parties' briefs attribute a greater degree of significance to the precise level of the target rates than was originally intended by the Department; and (3) adopting the Plan

[78] NYNEX notes that AT&T correctly states the law regarding the "reasoned consistency" doctrine in that "regulated companies should not be `subject to erratic changes in [regulatory treatment]' ... [however] it is clear that the Department may adopt new regulatory policies, as long as `accompanied by a statement of reasons for the decision ...'" (NYNEX Brief at 272, citing Boston Gas Co. v. Department of Pub. Utils., 367 Mass. 92 (1975)). NYNEX asserts that there is "ample record evidence" in this case to justify adoption of the Company's Plan (id.).

prior to completion of the transition process better meets the Department's goals and objectives than delaying implementation of the Plan pending completion of the transition process (id. at 271-274).

b. Attorney General

The Attorney General asserts that the Department should accept NYNEX's proposal to discontinue the transitional rate-restructuring (Attorney General Brief, Part I, at 17). The Attorney General argues that the target rates are based on data that are "wholly unreliable for setting current rates" (id.). The Attorney General maintains that the Department should require a full cost allocation and rate-design review in order to establish a cost-based starting point for the price cap (id.).

The Attorney General argues in addition that the Department "again order [NYNEX] to propose an unlimited eastern LATA calling plan in its next filing, whether it be a transitional filing, an annual price cap compliance filing, a rate case filing, or some other filing" (id. at 103). The Attorney General argues that if the Company fails to make such a proposal in its next filing, it be penalized, for example, through the quality of service adjustment in the Attorney General's Plan (id. at 103-104).

c. AT&T

AT&T argues that NYNEX's proposal to abandon the transitional rate-restructuring is unsupported by evidence or economics (AT&T Brief at 30). Therefore, according to AT&T, as a matter of law and policy, the Department should reject NYNEX's proposal (id. at 34-35). AT&T argues that the Company's position is based on its witnesses' "conclusory assertions that abandonment of the transition process ... is somewhat okay because the Department is not required to adhere mindlessly to its prior decisions" (AT&T Reply Brief at 5). AT&T argues that the Company has submitted no evidence in this proceeding to support deviation from prior Department decisions (id.).

In response to the Company's argument that the current rates have been found to be just and reasonable and thus are the appropriate starting point for the Plan, AT&T argues that Department approval of the current rates was given "explicitly on the basis that they would be in effect on a transitional basis only, until ... the next transitional tariff filings" (AT&T Brief at 31). AT&T states that the Department has declared that the target rates achieve the Department's public policy goals (id.).

In response to the Company's argument that current earnings are reasonable, AT&T argues that this point is irrelevant to the issue of whether the current rates or the target rates are better designed to achieve the Department's goals (id. at 32). If the appropriateness of the starting point rates for the Plan is based on the reasonableness of the Company's earnings, according to AT&T, then an immediate move to target rates would achieve appropriate starting rates because such a move would be revenue neutral (id.).

AT&T notes that the Department, in D.P.U. 93-125, stated: "In light of the increasingly competitive markets in which the Company operates, and the imminence of competition at the local exchange level, it is more important then ever that steady progress toward cost-based rates be maintained" (id. at 32-33, citing D.P.U. 93-125, at 20). AT&T argues that NYNEX's direct case is "devoid of any suggestion as to why the Department should not require NYNEX to continue to make progress toward cost-based rates" (id. at 33).

AT&T asserts that it is "noteworthy" that Dr. Taylor does not address the issue of the proposal to discontinue the transitional rate-restructuring (id.). AT&T notes that Dr. Taylor offered no attempt to justify the proposed basic residential rate freeze [79] on either economic or social grounds, and that any attempt to do so would have run "directly afoul of the Department's prior pronouncement of its intent to move away from the historical pricing of NYNEX's services based on the achievement of social purposes toward pricing based on cost in

[79] The current residential dial-tone line monthly rate is $9.91, and the Company has proposed to freeze that rate, among others, until August 2001 (see Section III.C.2, supra). Under the transitional rate-restructuring, the residential dial-tone line monthly rate would have increased to the target rate of $15.00 in two additional transitional filings (see D.P.U. 93-125, at 20).

order to enhance the development of competitive telecommunications markets" (id., citing D.P.U. 93-125, at 4-5).

AT&T notes that its witness, Dr. Mayo, criticized the NYNEX proposal to discontinue the transitional rate-restructuring, and, in particular, criticized the proposed rate freeze as anticompetitive and uneconomic (id. at 34, citing Exh. AT&T-145, at 20-21). In addition, AT&T argues that Mr. Caldwell, in his rebuttal testimony, demonstrated how the proposed rate freeze would directly inhibit the ability to achieve cost-based pricing for the Company's other services, including toll and switched access (id., citing Exh. NYNEX-39, at 16-18).

d. MCI

MCI argues that the Department should accept NYNEX's proposal to discontinue the transitional rate-restructuring, but only to the extent that NYNEX would agree to align its rates for services that are essential inputs for its competitors with the incremental cost of those services (MCI Brief at 36).

e. NECTA

NECTA argues that the transitional rate filing process should be completed if existing regulation is maintained. If price regulation is adopted, implementation should proceed first with completion of the transitional rate filing process, along with a revenue requirement/cost allocation proceeding (NECTA Brief at 22-23). NECTA submits that, in order for meaningful competition to develop, the transitional rate filing process should be completed (id. at 23).

NECTA argues that "it would be arbitrary or capricious for the Department to abandon suddenly the transitional rate filing process only months after the Department committed itself to completion of this process," [80] and that NYNEX has presented "no compelling reason" for the Department to discontinue the transitional rate-restructuring (id. at 24). NECTA further argues that NYNEX has not claimed that completion of the transitional rate-restructuring: (1) is confiscatory; (2) will deprive the Company of pricing flexibility; or (3) is unduly burdensome to the Company, harmful to ratepayers, or likely to alter the Company's pre-existing infrastructure plans (id.). NECTA also submits that NYNEX has not justified its proposal to discontinue the transitional rate-restructuring based on the level of competition that it now faces (id.).

According to NECTA, NYNEX observed that a transitional process can be included under a Department directive that price regulation be phased in over time (id.). NECTA submits that "such a gradual approach will allow the Department to address and implement `market structure' changes in the same time frame that

[80] NECTA notes that, the Department, in D.P.U. 93-125 (issued January 14, 1994), stated that it remains committed to achieving a rate structure for NYNEX that will enable greater competition in the industry (NECTA Brief at 21, citing D.P.U. 93-125, at 9-10).

NYNEX moves to price regulation" (id. at 24-25).

f. FEA

FEA argues that the Department should defer consideration of the Company's Plan until the transitional rate-restructuring is complete (FEA Brief at 4). FEA asserts that although the Plan does not preclude continued movement toward target rates (with the exception of basic residential service), NYNEX does not show a commitment to such movement (id.). FEA maintains that the record supports rejection of NYNEX's Plan "for the sole reason that [it] disrupt[s] the transitional rate process" (FEA Reply Brief at 3).

FEA argues that the target rates approved in D.P.U. 89-300 are best designed to achieve the Department's policy goals, and, accordingly, the current rates are not the appropriate starting point for alternative regulation (id. at 7). In response to NYNEX's argument that the current rates are a good starting point because they have been approved by the Department, FEA argues that the Department approved the target rates on a temporary basis for one year (id.).

In addition, FEA argues that completion of the transitional rate-restructuring process (1) is critical for NYNEX to compete; and (2) will not adversely affect universal service in Massachusetts (FEA Brief at 5-8).

g. NELF

NELF asserts that the transitional rate-restructuring was intended to allow NYNEX and its customers to move from "one economic reality to another," and that "if market realities have changed enough to warrant replacement of the final two stages of the rate-restructuring, then that should be done" (NELF Reply Brief at 3). NELF argues that the Department has the discretion to deal with any situation where a NYNEX customer has made "irrevocable commitments based on a legitimate expectation that NYNEX rates would move along the lines anticipated when the rate-restructuring was begun" (id.).

h. Mitchell Ziegler

Mr. Ziegler asserts that the Department should "force" implementation of an unlimited intraLATA telephone service (currently available in the 413 LATA) in the 617/508 LATA (Ziegler Reply Brief at 1). [81] Mr. Ziegler argues that NYNEX's lack of comment on such a service in the Company's initial brief could mean that the Company "no longer ha[s] a problem with creating the service" (id.).

2. Analysis and Findings

As AT&T correctly notes, the "reasoned consistency" doctrine

[81] Regarding specific details of such a service, Mr. Ziegler offers the following suggestions: (1) the service should be called "Bay State East Unlimited;" (2) the price should not exceed $60.00 per month; and (3) NYNEX should file a proposed tariff for the service no more than 30 days from the date of the Order in this docket, with the service being offered no more than 30 days from the tariff filing (Ziegler Reply Brief at 1).

requires that when the Department adopts a new regulatory policy, it must provide a statement of reasons for the decision supported by record evidence. Boston Gas Co. v. Department of Pub. Utils., 367 Mass. 92, 104-105 (1975). Clearly, the transitional rate process, and the goals that underlie that process, have been fundamental to the Department's regulation of NYNEX since 1989. However, the record in this case demonstrates that there are compelling reasons for discontinuing the process. This can be accomplished without sacrificing the policy goals underlying the rate-restructuring. A discussion of these reasons follows.

Most parties, with the exception of the Attorney General, have argued against NYNEX's proposed termination of the transition process, and have argued for completion of the transition to target rates prior to implementation of a price cap for NYNEX.[82] As noted, supra, the intent of the transitional rate-rebalancing process has been to make NYNEX's rates more cost-based and thus improve the allocative efficiency of telephone service. The transition process is, therefore, a means to an end and not an end in itself. The Department is not abandoning its long-standing commitment to competition in

[82] Contrary to the parties' claims, NYNEX's current rates, which were found to be just and reasonable in the last transitional filing, D.P.U. 93-125, could serve as the starting rates for price cap regulation, even though specific rate elements are not all at target levels, assuming a finding of reasonableness based on the Department's earnings review (see Section VII).

telecommunications, so the promotion of allocative efficiency must and should be as important under price cap regulation as it has been under ROR regulation. Therefore, in determining whether to approve the Company's proposal to end the transition process in conjunction with implementation of a price cap, the Department must be reasonably certain that the Company's rates would continue to move toward economically efficient rates, and that this goal can be achieved in a similar or otherwise reasonable time frame.

As noted earlier, the degree to which economic efficiency for individual rates is promoted is a function of the rate element pricing rules allowed in a price cap. The reason for this is that NYNEX, with adequate control on its aggregate rates to prevent monopoly rent and with pricing flexibility, will price its services to achieve the greatest possible degree of economic efficiency (see Tr. 2, at 128, 186-187). Therefore, as will be discussed in following sections, we are adopting pricing rules for NYNEX that should give the Company the flexibility to achieve an economically efficient rate structure under a price cap, and thus achieve the goals toward which the transition process was working.

As noted by the Company, the three primary rates that are not at target levels are (1) switched access, (2) toll, and (3) residence exchange. Under the price cap plan the Department approves in this Order, the Company will be required to reduce switched access rates to target levels in two steps, i.e., by the 1996 annual filing (see Section VI.C.7, infra). In order to compete effectively, NYNEX should then reduce its toll rates in response to the access rate decreases. Accordingly, access and toll rates will continue movement toward target rates under the price cap plan. Regarding residence exchange rates, the record demonstrates that even though certain residential rates would remain below target levels for the term of the price cap plan, those rates exceed marginal cost, and thus failure to achieve target rates should not be anticompetitive. Accordingly, we find that if NYNEX implements a price cap as discussed, infra, then the Company's proposal to end the transitional rate-rebalancing process is reasonable and is so approved, even though not all target rates will be achieved under the price cap plan.

Regarding the Eastern LATA unlimited calling plan, the Department finds that such a service could offer meaningful benefits to customers in the 617/508 LATA. However, we believe that NYNEX should review a full twelve months' worth of data from the Western LATA unlimited calling plan, which went into effect on April 14, 1994, prior to filing such a service for the Eastern LATA. We direct the Company to file such a service for the Eastern LATA by January 1, 1996. In the alternative, the Company should file by January 1, 1996 a request, with detailed justification, not to provide such a service for the Eastern LATA. After allowing comment from interested parties, the Department will determine whether such a request should be approved.

C. Investment Commitments

When the Company filed its petition for alternative regulation, it indicated that it would make the following network infrastructure improvements:

- complete conversion of all central offices to digital switch technology by year end 1997;
- deploy Signaling System 7 statewide by year end 1997;
- deploy Advanced Intelligent Network ("AIN")[83] to approximately 97 percent of access lines by year end 1997;
- make locally-served (*i.e.*, not from a foreign exchange) basic integrated services digital network ("ISDN") services available to approximately 88 percent of customers by year end 1997;
- provide fiber route diversity (*i.e.*, redundancy in fiber connections) to all central offices by year end 1998;
- deploy fiber facilities to meet customer demand to the main campuses of all colleges and universities by year end 1998;

[83] AIN is a software platform that uses centralized databases to deliver new services, independent of switching elements. AIN supports such services as Calling Name Delivery, Call Screening, and Multi-Location Customized Dialing Plans. Wireless communications networks are also dependent on AIN (Exh. AG-365).

- deploy fiber facilities to meet customer demand to all psychiatric, chronic, and critical care hospitals by year end 1998;

- deploy fiber facilities to meet customer demand to all industrial office parks by year end 1998;

- complete interoffice fiber network by year end 1998; and

- deploy a fiber-based broadband network, [84] with initial deployment to approximately 330,000 access lines, by year-end 1995.

(Exhs. NYNEX-1, at 22-23; NYNEX-8, at 17-18; AG-297).

1. Positions of the Parties

a. NYNEX

NYNEX claims that the Plan provides the appropriate economic incentives for the Company to (1) make investment decisions that are based on customer demand and market risks, rather than on ROR criteria, and (2) invest in the state's telecommunications infrastructure (NYNEX Brief at 6, 21). The Company states further that the shift of investment risk to the Company's shareholders under price cap regulation is also appropriate (id. at 22).

NYNEX maintains that the call for new technology and innovative telecommunications services is growing rapidly, and

[84] Services with transmission rates of 1.544 Mbps or greater are commonly referred to as broadband services. Broadband capability provides for transmission of large amounts of high speed voice and data services to customers' premises. Broadband will also allow for future services, such as video dial-tone transport service and video-conferencing (Exhs. NECTA-94; AG-355).

that the use of those services is becoming more intensive and widespread among many segments of the Massachusetts economy (id. at 97-98). The Company contends that its improvements and network modernization plans will directly enhance productivity in Massachusetts through advanced voice and data communications technology and services that offer fast, reliable, and secure transport delivery to customers (id. at 98).

b. Attorney General

The Attorney General maintains that the investment component of the Company's Plan highlights concerns about cross subsidization and anticompetitive pricing (Attorney General Brief, Part I, at 91). He argues that if the proposed investments are used to serve non-utility operations, such as video programming, then it would be anticompetitive and unfair to require monopoly ratepayers to subsidize such ventures (id. at 93).

According to the Attorney General, there are a number of significant policy concerns raised by the Company's deployment of ubiquitous broadband capability: (1) the extent to which broadband costs are part of the Company's current and ongoing revenue requirement; (2) the anticompetitive effects of possible cross-subsidization; and (3) regulatory oversight regarding the deployment of any advanced technologies or services that are financed with monopoly revenues (id.). He therefore argues that the Department must maintain some regulatory oversight of the Company's construction activities, regardless of the form of regulation used for NYNEX in the future (id. at 94).

The Attorney General also maintains that the Company presented no reliable study showing productivity gains attributable to improvements in telecommunications infrastructure (id.). Therefore, he disputes NYNEX's statement that its investments in infrastructure, as opposed to investments by other providers, will spur economic development in Massachusetts (id. at 94-95).[85]

c. AT&T

AT&T argues that NYNEX is overstating the benefits of its investment commitments, and that the Company fails to discuss what infrastructure investments it would make if there were no change in the form of regulation (AT&T Reply Brief at 8). AT&T contends that NYNEX has an ongoing legal obligation to make investments to provide technologically-advanced telecommunications services throughout Massachusetts (id.).

With respect to NYNEX's claim that ratepayers will be protected from investment risks, AT&T argues that ratepayers would also be shielded from investment returns, and that it is

[85] The Attorney General agrees with NYNEX's proposition that investment in the state's infrastructure may offer positive economic benefits in an absolute sense (Attorney General Brief, Part I, at 95).

highly likely that ratepayers will provide interest-free funds for those investments (id. at 10). AT&T concludes that it is highly unlikely that any form of regulation will shield ratepayers from the risks of unsuccessful investment decisions by the Company (id. at 11).

d. MCI

MCI takes issue with the Company's voluntary commitment to make certain infrastructure investments, and argues that many of the infrastructure improvements are restatements of existing plans or slight accelerations of current plans (MCI Brief at 12-13). MCI argues that "the Department should not be fooled into thinking that alternative regulation is necessary or even appropriate to assist NET's ventures into the broadband arena" (id. at 14). MCI claims that the Company would make infrastructure investments whether or not it is granted alternative regulation (id. at 15-16).

MCI also agrees with the Attorney General's position that the Department should adopt regulatory oversight of the Company's infrastructure deployment, notwithstanding the type of regulation imposed on the Company (id. at 15).

e. NECTA

NECTA takes exception to the Department's determination in an earlier procedural Order that the scope and timing, but not the reasonableness of the infrastructure commitments, are within the scope of this proceeding, arguing that such rulings conflict with the record in this case (NECTA Brief at 63). NECTA states that the Company has suggested that it will not fulfill its public service obligations unless the form of regulation applied is changed (id. at 64). NECTA also argues that NYNEX's commitments are either existing plans, or involve only slight increments above current budgeted plans (id.). Therefore, NECTA concludes that the Company's Plan may result in no additional investment in the state's telecommunications infrastructure (id. at 64-65).

f. FEA

FEA takes issue with the Company's "unsupported" infrastructure improvements, arguing that the proposals would not be subject to adequate control by the Department (FEA Reply Brief at 5).

2. Analysis and Findings

Regarding the Company's proposed infrastructure investments, we have previously determined that only the scope and timing of the investments were issues that could be addressed by the parties and that would be considered by the Department in deciding whether to adopt price cap regulation for NYNEX. June 14, 1994 Interlocutory Order at 22-23.

During hearings, the Attorney General and NECTA, in making certain record requests, again sought to raise the reasonableness of the investment commitments as an additional issue to be examined in the case. In an Order affirming Hearing Officer Rulings that sustained NYNEX's objections to the record requests, the Department declined to expand the scope of examination to include the reasonableness of those investments. September 22, 1994 Interlocutory Order at 20-21. In responding to claims that the Company itself has made the reasonableness or cost-effectiveness of the investments an issue in the case by linking the investments to approval of its price cap plan, the Department previously stated:

> Although the Company's Plan and direct case have discussed the investment commitments, the commitments themselves are not part of the actual alternative regulatory methodology (i.e., the pricing rules, term, and other components of the alternative regulation scheme) for which the Department must make a determination of reasonableness in the final Order in this proceeding. According to the Company, it included the infrastructure improvements in its Plan to demonstrate NYNEX's strong intent to invest in the Massachusetts public telecommunications network under an alternative regulation scheme. The manner in which the Company has described its investment commitments in its Plan and direct case is consistent with this characterization. Moreover ... the Company has testified that it is not seeking Department approval of these investments either as part of this docket or at some later time in accordance with the Plan. While alternative regulation, according to the Company, would increase the Company's ability to make infrastructure improvements, and in this narrow sense creates a "link" between the investments and Department approval of the Company's Plan, this is not a compelling justification for us to consider the reasonableness of the investments.

Id. at 19-20.

As we noted, "[p]articularly in the rapidly evolving telecommunications industry, we do not believe that it would be appropriate for the Department to determine whether a given prospective investment is reasonable." Id. at 20.[86] Rather, we are concerned only with promoting through sound regulatory policy the proper investment environment to encourage efficient development, by NYNEX and/or other companies, of an advanced telecommunications network in Massachusetts. Accordingly, we repeat our earlier finding that we will not make a determination on the reasonableness of NYNEX's prospective investments.

Notwithstanding this determination, it is important to respond to certain arguments raised by intervenors regarding the proposed investments. First, we strongly disagree with the suggestion of some parties that the Department should adopt regulatory oversight of the Company's infrastructure investments regardless of the form of regulation. One of the primary advantages of well-designed price cap regulation is that it

[86] Moreover, our ultimate finding in this Order to adopt price cap regulation for NYNEX does not rest in any way upon the Company's voluntary commitment to make these investments, or upon claims about the benefits of these investments. Contrary to suggestions of NECTA and other parties, the record does not demonstrate that NYNEX would not fulfill its public service obligation unless the Department approved a price cap. It is in NYNEX's best interests -- a fact identified by parties opposing NYNEX's Plan -- to modernize its network in such a way as to respond to customer demand at least cost, and presumably such modernization would occur under any regulatory scheme.

insulates ratepayers from the Company's investment risks. If, under a well-designed price cap, the Company makes imprudent investments, the Company will be unable to raise revenues from ratepayers to cover these expenses. As noted, supra, the price cap formula only accounts for cost changes for the average firm in the industry (plus exogenous costs beyond the firm's control), and the expenses associated with imprudent investment would not be included in the price cap formula and would not be considered an exogenous cost. Therefore, we find that under a well-designed price cap, the Company's shareholders bear the risk of its investment.[87]

Regarding the parties' stated concerns about cross-subsidization and anticompetitive pricing related to the Company's proposed investments, the Department has adopted a price floor for NYNEX's services, as described, infra, in Section VI.C.1.b.ii, which should prevent cross-subsidization and anticompetitive pricing. In response to the Attorney General's and NECTA's argument that the Department should ensure that no nonregulated broadband costs are embedded in NYNEX's rates at the

[87] Underlying the parties' assertions that price cap regulation does not insulate ratepayers from investment risk is the assumption that the price cap formula has not been set correctly. We note that any form of regulation can be presumed unreasonable if you first assume that the implementation of it will be done incorrectly, but the Department's analysis in this Order is based on our firm conviction that we have created a well-designed price cap.

start of the price cap plan, we note that parties have been given the opportunity to present evidence about adjustments to reflect nonregulated investment expenses that should be removed from the Company's revenue requirement. The Department has considered those arguments and related evidence in making its findings on the reasonableness of the Company's current earnings (see Section VII).

In summary, we reaffirm our earlier finding that we will not judge the reasonableness of the Company's prospective infrastructure investments, and, as noted, we have adopted safeguards in the price cap plan described in this Order specifically to prevent cross-subsidization and anticompetitive pricing.

VI. PRICE REGULATION ISSUES

A. Overall Price Regulation Index

Both the Company and the Attorney General propose price cap formulas as a measure for allowed price changes in the aggregate.[88] The Attorney General refers to his price cap formula as the price cap index ("PCI"), while the Company calls its index the price regulation index ("PRI"). The PCI and PRI are both generally represented as: Inflation - X ± Z, where X[89]

[88] In addition, the Attorney General offers his price cap index as one of two possible caps (along with the CSPI) for specific rate elements in his proposed Basket 1.
(continued...)

consists of productivity growth, input price growth, and a stretch factor, and Z represents exogenous cost changes. The Attorney General's price cap formula also includes a quality of service element. As noted earlier, the price cap formula is intended to represent annual cost changes for the average firm in the industry.

1. Inflation Measure

In the Company's price cap formula, GDP-PI serves as a measure of the change in national output prices.[90] The Attorney General argues that the GDP-PI in a price cap formula represents input price growth. However, the Attorney General also argues that GDP-PI is not a sufficient representation of input price changes for local exchange carriers ("LECs") because the LEC industry experienced significantly lower average annual input price growth than the overall economy did during the years 1984-1992 (see Section VI.A.2.a.ii(B), infra). The Attorney General does not use a different measure of inflation to compensate for the input price differential; instead, he

[89](...continued)

[89] The X factor is also commonly referred to as the productivity offset or productivity factor.

[90] The Company argues that there is no difference between the input price growth rates of the LEC industry and the U.S. economy, but that if there was such a difference, an input price differential would be included in the price cap formula as a separate component of the productivity offset (see Exh. NYNEX-37, at 5).

recommends an input price differential as an additional component of the productivity offset. The appropriateness of including such a component will therefore be considered below in the analysis of the proper productivity offset.

a. Positions of the Parties

i. NYNEX

The Company argues that the GDP-PI is the appropriate inflation index to use in the price cap formula because it is (1) more stable than other standard inflation indices, (2) more readily available, and (3) maintained on a more timely basis than other standard indices (NYNEX Brief, App. B at 10).

ii. Attorney General

The Attorney General also argues that the GDP-PI is the appropriate inflation measure in a price cap formula (Attorney General Brief, Part I, at 19). According to the Attorney General, the principal benefit of using GDP-PI is that it is more likely to measure the output price changes for the bundle of goods and services whose total factor productivity ("TFP") growth is measured by the Bureau of Labor Statistics (id., citing Exh. AG-795, at 25; Exh. NYNEX-3, at 13-14).

b. Analysis and Findings

No party disputes that GDP-PI is the appropriate measure for inflation in a price cap formula. The record indicates that the GDP-PI is (1) the most accurate and relevant measure of the output price changes for the bundle of goods and services whose TFP growth is measured by the Bureau of Labor Statistics, (2) readily available, (3) more stable than other inflation measures, and (4) maintained on a timely basis. Accordingly, we find that the GDP-PI should be used in NYNEX's price cap formula.

2. Productivity Offset

As noted, the productivity offset in a price cap formula consists of productivity growth, input price growth (if appropriate), and a stretch factor. In the Company's Plan, the productivity offset consists of the differential between the TFP growth of the LECs and the economy as a whole, plus a consumer productivity dividend, or "stretch" factor. In the Attorney General's proposal, the productivity offset consists of (1) the TFP growth of the LEC industry; (2) the input price differential between the LECs and the economy as a whole; and (3) a stretch factor.

a. Positions of the Parties

i. NYNEX

The Company asserts that the purpose of a productivity offset in a price cap formula is to ensure that the firm's average prices change at a just and reasonable rate (NYNEX Brief, App. B at 11). NYNEX recommends that the productivity offset equal 2.5 percent, reflecting a two percent productivity differential, plus a 0.5 percent stretch factor, or consumer productivity dividend (id.).

(A) TFP Growth Rate

The Company's witness, Dr. Taylor, recommended that the productivity offset should be calculated by comparing the annual historical TFP growth differential between the LECs and the United States economy as a whole (id. at 36). Dr. Taylor argued that it is appropriate to use a long-run value of productivity historically achieved by the telecommunications industry rather than one specific to the Company, since following the latter approach would distort the Company's incentive to increase productivity (id. at 36-37, citing Exh. NYNEX-3, at 20). The Company maintains that in order "to obtain the full benefit of incentives to increase productivity growth and achieve the highest possible dynamic efficiency, the productivity target must be fixed or constant over time so that the regulated firm will treat that target as independent of any of its actions" (id. at 37, citing Exh. NYNEX-3, exh. C at 7).

The Company maintains that, to establish the productivity target, one must first determine how to measure the historical productivity differential. The Company further notes that it and the Attorney General disagree on the appropriate information and the interpretation of that information in determining the differential (id. at 38). The Company argues that its witness, Dr. Taylor, has presented ample evidence to support the Company's use of a two percent productivity differential (id. at 39). The Company notes that Dr. Taylor employed two different methods, direct and indirect, to measure the difference between the telecommunications industry and national average productivity change, and argues that the results of both methods support its conclusion (id.).[91]

The Company states that Dr. Taylor relied upon nineteen industry productivity growth studies, eight direct and eleven indirect, spanning a 65-year period (id. at 40). The Company argues that these studies are a better indicator of actual variances in growth rates because intermittent short-term fluctuations in the industry growth rate are averaged over time (id. at 41, citing Exh. NYNEX-37, at 21). Further, the Company argues that the telecommunications industry has historically been marked by technological innovation and that the Attorney General has provided no evidence to quantify how new technologies will impact productivity growth differently from technologies that have emerged in the past (id. at 41, citing LEC Price Caps, 1990 FCC LEXIS, 1371, at s. 107 (1990)).

[91] NYNEX states that (1) the direct method is based on comparing TFP studies, measuring directly the growth rates of outputs and inputs, and (2) the indirect method is based on comparing the change in output prices for the industry and the United States economy as a whole. When input prices are the same for the local exchange carriers and the economy, the difference between output price growth rates equals the productivity differential (NYNEX Brief at 39-40).

The Company argues that the Attorney General's witness' dismissal of the studies employed by Dr. Taylor as "outdated and not reflective of the current period of technological change" is wrong (id. at 40). The Company states that the Attorney General solely relies upon and improperly interprets the 1994 Christensen Study,[92] and that the Attorney General erroneously concludes that the 1994 Christensen Study supports a 5.2 percent productivity offset, consisting of a 2.6 percent TFP differential and a 2.6 percent input price growth differential (id. at 38, citing Attorney General Brief, Part I, at 48-50).[93] The Company argues that the Attorney General's witness, Dr. Roddy, did not conduct an independent analysis of the 1994 Christensen Study and that Dr. Roddy's opinion is "unsubstantiated by any record evidence and antithetical to the opinions of Dr. Christensen and Dr. Taylor" (id. at 38).

The Company argues that the Attorney General's reliance upon the 1994 Christensen Study as the sole appropriate study because

[92] The 1994 Christensen Study is a TFP study of the seven Regional Bell Operating Companies ("RBOCs"), GTE, and Southern New England Telephone Company for the period 1984-1992, done by Dr. Laurits Christensen (one of NYNEX's witnesses in the current proceeding) on behalf of the United States Telephone Association ("USTA") in the FCC LEC Price Cap Review (Docket No. 94-1) (Attorney General Brief, Part I, at 50, citing Exhs. AG-76, AG-77).

[93] The Company notes that the Attorney General adds an additional 1.0 percent stretch factor to his proposed X factor, for an overall productivity target of 6.2 percent (NYNEX Brief at 38).

it is the only post-divestiture study, is incorrect (id. at 42). The Company states that Dr. Roddy has provided no evidence to support his belief that the AT&T divestiture has affected LEC productivity growth (id. at 42, citing Exh. NYNEX-37, at 21). Further, the Company states that Dr. Roddy failed to offset the 2.6 percent Christensen TFP by 0.3 percent, which was the average United States TFP growth rate for the 1984-92 period (id. at 42-43, citing Exh. NYNEX-37, at 6). The Company states that by subtracting the 0.3 percent United States TFP growth rate, the result is a productivity offset of 2.3 percent for the 1984-92 period, which, according to NYNEX, is comparable to the two percent figure proposed by the Company (id. at 43).

(B) Input Price Differential

The Company explains that, in addition to the dispute regarding the TFP growth rate, the matter of input price growth rate in the price cap formula is an area of disagreement between the Company and the Attorney General (id. at 43).

The Company states that Dr. Taylor's eight direct TFP productivity studies, including the 1994 Christensen Study, and the eleven indirect productivity studies, support the conclusion that the input price growth differential for the United States economy and the telecommunications industry is zero over long periods of time (id. at 45). The Company states that Dr. Taylor's analysis shows that for some sub-periods the LEC input prices grew more rapidly than the total United States economy, and for other periods the reverse was true; however, over time, those discrepancies balance out, as "evidenced by the 65 years of productivity study data in this case" (id. at 47). The Company states that Dr. Taylor's use of a conventional T-test approach to demonstrate the statistical significance of the difference between two averages shows that there is no legitimate basis to infer that the input growth rates of LECs and the economy are different over time (id.).

The Company argues that the Attorney General's exclusive reliance upon the 1994 Christensen Study is disputed by Dr. Christensen himself, and is disproved by Dr. Taylor's tests for statistical validity (id. at 46, citing Exh. NYNEX-37, at 13, exh. 1). The Company argues that the Attorney General completely mischaracterizes the relationship between the GDP-PI rate and the LEC input price growth rate and mischaracterizes the role input prices play in determining the productivity target (id. at 44). The Company argues that Dr. Roddy's recommendation to include an input price growth differential of 2.6 percent, in the determination of the correct productivity offset, is "based on an apples and oranges comparison" (id. at 44). The Company argues that Dr. Roddy improperly employs the GDP-PI in the calculation of an input price differential, as it is a measure of output prices and not a measure of input prices, and that he has presented no evidence to support his conclusion that the GDP-PI measure of output prices is identical to the economy-wide input price growth rate for that same period (id. at 44-45).

The Company states that Dr. Christensen testified that there is no difference between the average input price growth rate of the average LEC and the United States economy (id. at 49, citing Tr. 27, at 34-35). The Company further states that Dr. Christensen attributes the variation of input price growth during 1984-92 to a "dramatic" decline in interest rates and a 1986 reduction in federal corporate income taxes which affected the LECs more than the rest of the United States economy (id. at 50, citing Exh. NYNEX-38, at 11; Tr. 27, at 28-30, 36-37). The Company states that Dr. Christensen does not expect this anomaly to occur in the future and, more specifically, during the term of the Company's Plan (id. at 50, citing Tr. 27, at 30).

The Company notes that Dr. Christensen offered another explanation for the anomaly (id. at 50). According to NYNEX, Dr. Christensen stated that the economy-wide opportunity cost of capital did not reflect the decline in interest rates during the 1984-92 period, which may have given the impression that the LEC opportunity cost of capital declined substantially relative to other United States firms (id. at 50, citing Exh. NYNEX 38, at 11-12). The Company argues that this apparent difference in the cost of capital is not accurate, and, "if anything, [input prices] are likely to come closer together, which will create the likelihood that capital input prices for the LECs will rise more rapidly rather than more slowly than for the rest of the economy" (id. at 51, citing Tr. 27, at 32; Exh. NYNEX-38, at 12).

The Company further argues that if Dr. Christensen is correct and the LEC's input price growth rate is rising more rapidly that the United States economy's, then the 2.6 percent component would be a double whammy for the Company (id. at 51, citing Tr. 27, at 32). Therefore, the Company concludes that the input price growth differential employed in determining the productivity target should be zero (id. at 51). Also, the Company states that the Attorney General is wrong in his claim that Dr. Taylor concurs with Dr. Roddy's comparison of output and input data to derive an input price differential and indicates that Dr. Roddy's comparison is unfounded (NYNEX Reply Brief at 23).

The Company argues that the Attorney General's reliance on the recent decision by the Vermont Public Service Board in support of his position on the input price differential is misplaced (id. at 22). In addition, the Company takes issue with the Attorney General's characterization of the Illinois price cap regulation plan detailed in Illinois Bell Telephone Company , 92-0448/93-0239 Consol. (Ill. Commerce Comm'n 1994), 156 P.U.R. 4th 121, 150-51 (1994) (id. at 23-24). The Company notes that even though the Illinois Commission included an input price differential in its productivity target, the 2.5 percent input price differential component proposed by Dr. Roddy in Illinois was reduced by 0.5 percent by the Illinois Commission to reflect the impact of tax law changes that affected Illinois Bell's input prices differently from non-telecommunications industries (id. at 24). The Company states that other jurisdictions have reached different conclusions regarding the input price differential as a component of a productivity target and notes that the Ohio Commission recently approved a price cap plan including a productivity offset of three percent with no input price differential component (id. at 24, citing Ohio Bell Telephone Company, 93-487-TP-ALT and 93-576-TP-CSS, at 67-68 (Ohio Pub. Utils. Comm'n) (1994)).

(C) Consumer Productivity Dividend

The Company proposed a 0.5 percent consumer productivity dividend, in order to "provide[] ratepayers with an appropriate share of the productivity gains arising from changes in regulation and technology (NYNEX Brief at 36).

ii. Attorney General

The Attorney General argues that the appropriate determination for the productivity offset of the price cap formula "will be among the most important decisions made in this proceeding," as the X component will establish the level of the real price change during the term of the plan (Attorney General Brief, Part I, at 48). The Attorney General argues that with relatively high increases in productivity in the telecommunications service industry, it is clear that telephone service prices in a competitive market will increase at a slower rate or decrease at a faster rate than prices in the economy as a whole (id. at 48-49). Therefore, according to the Attorney General, the productivity offset is intended to: (1) account for the expected differential in productivity growth between the industry and the economy as a whole; (2) account for the expected differential in the rates of inflation in the industry's input factor prices and the economy's as a whole; and (3) incorporate a "consumer dividend" or "stretch factor" to reflect anticipated efficiency gains to be achieved as a result of the plan (id. at 49).

The Attorney General recommends that the Department adopt his proposed 6.2 percent productivity offset in order to "stimulate the cost reductions and pricing responses that would prevail for companies operating in a nonregulated competitive market" (id. at 63). The Attorney General argues that if the price cap adjustment mechanism does not reflect that the Company's input prices are rising more slowly than the economy in general, then the Company would be reimbursed at a higher rate than its actual expenses, and the rates charged would be higher than the rates that would prevail in a competitive market (id. at 62). According to the Attorney General, the Company's 2.5 percent productivity offset would result in a steady stream of revenue increases for its non-competitive services customers (id.). The Attorney General argues that these revenue increases would conflict with the statutory requirement of just and reasonable rates and would increase the potential for anticompetitive and uneconomic infrastructure deployment available to the Company as the dominant provider of telecommunications services in Massachusetts (id. at 62-63).

The Attorney General recommends a 6.2 percent productivity offset comprised of the following components: (1) 2.6 percent TFP factor; (2) 2.6 percent input price differential; and (3) one percent consumer productivity dividend (id. at 19).

(A) TFP Growth Rate

The Attorney General states that the TFP growth rate of a LEC is measured as the output growth rate minus the input growth rate (id. at 49).[94] The Attorney General states that the "Divisia Index," which creates a weighted average of the growth rates based on the proportion of total input expenses that each

[94] According to the Attorney General, the output growth rate is the combination of physical measures sold to the public (e.g., phone calls, directory assistance, access line connections) and the input growth rate is a combination of physical measures such as capital, labor, and materials used to produce services (e.g., number of employees or number of hours worked) (Attorney General Brief, Part I, at 49).

input represents, is the most commonly used method to calculate TFP (id., citing Exh. AG-810, at 16-20).

The Attorney General asserts that the disagreement between the Company and the Attorney General on TFP rests not on the calculations of TFP growth rate, but rather on the time periods used in the calculations (id. at 50). For purposes of his TFP analysis, the Attorney General's witness, Dr. Roddy, relies on a study done by Dr. Christensen that included the seven Regional Bell Operating Companies as well as GTE and Southern New England Telephone Company for the post-divestiture time period of 1984-92 (id.). According to the Attorney General, Dr. Roddy found that, between 1984-1992, total input grew at an average annual rate of 0.9 percent, while total output increased at an average annual rate of 3.5 percent, thus resulting in an average annual LEC TFP growth rate of 2.6 percent (id. at 50, citing Exhs. AG-810, at 22, Table 6; AG-76; AG-77).

The Attorney General cites a recent decision by the Vermont Public Service Board ("Vermont Board") as support for his contention that Dr. Taylor, who testified on the same issues in the Vermont Board's investigation, relied on TFP studies that are "outdated" (Attorney General Reply Brief at 20). The Attorney General quotes the Vermont Board as follows:

> The studies on which Dr. Taylor based his determination of TFP growth are outdated studies and are based on costs of a broad range of industries, not merely the local exchange industry. Only two of the studies that

> Dr. Taylor relies upon evaluate productivity growth in the Bell system, but both use data series that end with the year 1979. Divestiture and major conversions to digital/fiber equipment occurred well after this time period, for LECs generally and for [NYNEX] in particular. Hence, we have chosen not to rely upon Dr. Taylor's 2.5 [percent] productivity offset.

(id. at 20, citing New England Telephone and Telegraph Company, Dockets Nos. 5700/5702 (Vt. Pub. Serv. Bd. 1994), 157 P.U.R. 4th 112, 172 (1994)).

The Attorney General asserts a number of reasons that the studies relied on by the Company's witness, Dr. Taylor, in his TFP analysis, were defective (Attorney General Brief, Part I, at 50-53). The Attorney General argues that Dr. Taylor's first group of studies, which include data from the 1940s through the 1970s, are out of date and do not capture the changes in industry structure and technology that have occurred since 1984 (id. at 51). According to the Attorney General, Dr. Taylor's second group of studies, which include post-divestiture data (1984-88) are "clearly poor quality productivity studies" and are defective in a number of critical respects (id.). The Attorney General concludes that all of the studies relied upon by the Company are wanting and that, therefore, the 2.6 percent TFP growth rate recommended by the Attorney General should be adopted by the Department as the TFP growth rate component of the X factor (id. at 53).

(B) Input Price Differential

The Attorney General argues that the use of GDP-PI as a measure of LEC input price inflation must be adjusted to include the past performance of GDP-PI relative to the actual input price inflation experienced by LECs (id.). Otherwise, according to the Attorney General, if the Company's input prices rise more slowly than those of the economy as a whole, the Company would be reimbursed at a higher rate than its actual expenses, to the detriment of the ratepayer (id.).

Employing the 1994 Christensen Study's input price data, the Attorney General asserts (1) that LEC input prices grew at an annual average rate of approximately 1.1 percent for the 1984-1992 time period, and (2) that the GDP-PI during the same period grew at an annual average rate of 3.7 percent (id.). Therefore, the Attorney General asserts that because LEC input prices grew at an average annual rate 2.6 percent lower than GDP-PI, the input price differential component of the X factor should be 2.6 percent (id. at 53-54).

The Attorney General disputes the Company's argument that the input price differential for the 1984-1992 time period is an anomaly (id. at 54). The Attorney General argues that the pre-1984 data is confounded by the inclusion of the data for interexchange carrier input prices and, of greater significance, does not take into consideration the productivity increases in the telecommunications field since 1984 (id. at 55).

The Attorney General disputes the Company's use of a statistical T-test to determine the validity of the Attorney General's proposed input price differential component (id.). The Attorney General argues that the Company's attempt, on rebuttal, to employ a T-test is poor statistical practice, and in direct contradiction to earlier Company LEC input price differential analysis (id.). Further, the Attorney General asserts that "Dr. Taylor's last minute result oriented adoption of this erroneous position should cast considerable doubt on the credibility of any testimony he has given" (id. at 56).

The Attorney General contends that Dr. Taylor did not rely on the new Christensen study because his X factor determination would then yield the identical result as the Attorney General (id. at 59). As such, according to the Attorney General, Dr. Taylor came up with the T-test to try to keep his X factor at 2.5 percent (id.).

The Attorney General states that Dr. Taylor's T-test is totally unpersuasive given the following factors: (1) Dr. Taylor had relied on the "simple difference between two averages" test for years before numerous regulatory bodies; (2) Dr. Christensen has never used a statistical test to calculate the input price differential; and (3) Dr. Roddy testified that the application of the statistical test to the input price issue is clearly inappropriate (id. at 59-61). Therefore, the Attorney General argues that "the Department should reject Dr. Taylor's result-oriented attempt to falsely deflate the input price differential component of the X factor," and should adopt a 2.6 percent input price differential (id. at 61).

In addition, the Attorney General states that the Illinois Commission recently rejected Dr. Christensen's argument that the 1984-1992 time period represents an anomaly in LEC input prices, and included a two percent input price differential as a component of its approved X factor of 4.3 percent (Attorney General Reply Brief at 21-22, citing Illinois Bell Telephone Company, 92-0448/93-0239 Consol. (Ill. Commerce Comm'n 1994), 156 P.U.R. 4th 121 (1994)).

The Attorney General contends that the Company's argument that comparing the GDP-PI to LEC input prices results in an "apples to oranges" comparison is wrong (id. at 23). The Attorney General argues that Drs. Roddy, Christensen, and Taylor all agree that the economy-wide input prices are equal to the GDP-PI rate plus the economy-wide TFP rate (id. at 23-24, citing Exhs. AG-810; AG-816; NYNEX-37, at 12; Tr. 26, at 151-152; Tr. 27, at 17-18). The Attorney General argues that his proposed 2.6 percent input price differential uses the GDP-PI as a reference, but the result is identical if the economy-wide input prices are instead used as a reference (id. at 24).

(C) Consumer Productivity Dividend

The Attorney General argues that an alternative regulation plan is intended to introduce a form of regulation superior to ROR regulation, and, therefore, results of the new incentives should be reflected in a consumer productivity dividend (Attorney General Brief, Part I, at 61, citing Exhs. NYNEX-3, at 7; NYNEX-37, at 7). According to the Attorney General, the consumer productivity dividend represents an advance commitment of the regulated utility to flow a portion of the benefits of price cap regulation through to consumers (id. at 61).

The Attorney General proposes a one percent consumer productivity dividend and bases his position on (1) the California PUC's finding that about 1.5 percent to perhaps two percent of the adopted productivity adjustment will rise from the heightened incentives in the new regulatory framework, and (2) the FCC's application of a 0.5 percent consumer dividend adjustment (id. at 62). The Attorney General concludes that the Department should adopt a one percent consumer productivity dividend as the third and final component of the X factor (id. at 61-62).

iii. AT&T

AT&T argues that the productivity offset should be no less than that recommended by the Attorney General, i.e., no less than 6.2 percent (AT&T Brief, App. B at 5). AT&T states that the single most important element of the Company's proposed price cap formula is the productivity offset,and that the Company's proposed 2.5 percent productivity offset is utterly inadequate (AT&T Brief at 48).

AT&T states that if the Company's Plan had been in place from 1984-93, the Company would have been entitled to annual general rate increases ranging from 0.3 percent to two percent and that the cumulative impact of the annual increases would have been an overall rate increase of between twelve and 13 percent (id. at 49, citing Exh. AT&T-131; Tr. 19, at 27-30). AT&T asserts that this would have resulted in Massachusetts ratepayers paying in excess of $100 million more per year than they have been required to pay under ROR regulation (id. at 49).

iv. MCI

MCI argues that the 6.2 percent productivity factor recommended by the Attorney General is a more realistic estimate of the Company's productivity improvements under incentive regulation than the 2.5 percent productivity factor proposed by the Company (MCI Brief at 29). MCI states that the Company has relied on historical estimates of productivity and has not factored in any of the productivity improvements likely to result from process re-engineering initiatives, or from efficiencies that will be required through competition (id. at 30, citing Tr. 2, at 164). MCI therefore concludes that the Company has underestimated the productivity growth that it is likely to achieve over the life of the plan (id. at 30).

v. NECTA

NECTA states that if the Department adopts any form of price regulation, it should adopt the plan sponsored by the Attorney General (NECTA Brief at 97). According to NECTA, the Attorney General's productivity factor is more representative of what the Company can reasonably be expected to achieve based upon post-divestiture experience, rapid deployment of less maintenance intensive technology, substantial downsizing, and process re-engineering initiatives (id. at 97-98).

NECTA states that securities analysts envision a 7.5 percent compound productivity factor over the next several years, and argues that the Department should expect the Company's productivity factor for Massachusetts to be at least as great, if not greater than the four percent recently adopted by the Vermont Board for NYNEX's Vermont operations (id. at 98). NECTA states that the Company also overlooks the extent to which its actual revenues are increased by sales growth, and how sales growth has the effect of increasing actual productivity under the Plan's formula (NECTA Reply Brief at 11-12, citing Tr. 1, at 171-173).

NECTA also states that the Company's costs are expected to decline rapidly (35-40 percent) in the short term (1994-97) (NECTA Brief at 67, citing Exh. NECTA-110); and that the investment community expects the Company to realize annual productivity gains of 7.8 percent compounded over several years, without the benefit of price regulation (id. at 30, citing Exh. NECTA-166, at 3).

vi. FEA

FEA argues that the Company's proposed 2.5 percent productivity factor (1) is much too small, (2) does not provide an adequate incentive for the Company to improve its performance, and (3) may unjustly reward the Company for less than average performance (FEA Brief at 15).

FEA argues that the Company's analysis is flawed because: (1) it does not consider the productivity of suppliers to the LECs; (2) the most recent data employed is seven years old; and (3) it does not factor in the major process re-engineering program upon which the Company has embarked, and which is expected to result in the elimination of 6200 jobs by the end of 1996 (id. at 15-16, 22).

FEA notes that both the FCC and California PUC have adopted larger productivity factors than the Company proposes (id. at 16). According to FEA, the FCC's price cap for LECs provides the carrier with a choice of 3.3 percent or 4.3 percent, depending upon the earnings sharing point, and the California Commission has adopted a productivity factor of five percent (id.).

In addition, FEA states that in its "Price Cap Review," the FCC sought comments on a proposal to increase the productivity offset for the interstate operations of the local exchange carriers (id.). FEA notes that, pursuant thereto, AT&T conducted a productivity analysis which indicated that the actual performance of the Bell Operating Companies ("BOCs") was equivalent to a productivity offset of 5.97 percent during the period January 1991 to December 1993 (id.). Therefore, according to FEA, a productivity offset of 5.97 percent would have resulted in constant earnings for the composite of all seven BOCs (id.). According to FEA, the constant earnings offset for NYNEX alone was 3.48 percent (id.).

FEA, therefore, recommends that the Department specify a productivity factor of at least four percent if it adopts price cap regulation for the Company (id.).

b. Analysis and Findings

Determining the appropriate productivity offset is the most important and most difficult part of creating a well-designed price cap plan -- important because it determines the level of aggregate rate change for the firm, and difficult because it requires regulators to predict the average annual TFP and input price growth of the industry over the term of the price cap plan.[95] The productivity offset is even more important if there

[95] It is this necessity of predicting the future that indicates that price caps, while potentially better than ROR regulation at simulating the competitive outcome, are inferior to actual competitive markets. Therefore, as (continued...)

is no earnings sharing mechanism, because earnings sharing, in theory, serves as an insurance policy for the productivity offset.[96] Based on the record in this case, the Department finds that the appropriate productivity offset for NYNEX is 4.1 percent. The specific reasons for this finding are outlined below.

The Company has demonstrated that a price cap formula for the average firm in the telecommunications industry over the past 65 years would have required a productivity offset of two percent, in order to keep earnings constant over that period. The Attorney General has also demonstrated that a price cap formula for the average firm in the industry in the years 1984-1992 would have required a productivity offset of 5.2 percent, in order to keep earnings constant over that period. While both are correct in terms of measuring the historical

[95](...continued) noted, supra, the Department remains committed to promoting full, effective competition in all telecommunications markets in Massachusetts as a more effective means than regulation at ensuring the benefits of efficiency in the provision of telephone services. See Local Competition , D.P.U. 94-185, at 3 (1995) (Vote to Open Investigation).

[96] Earnings sharing is intended to act as an insurance policy because if an X factor is set such that a utility earns excess profits, earnings sharing at least will ensure that ratepayers share in a percentage of those so-called monopoly profits. However, if the X factor is set correctly, additional earnings will be derived only from above-average gains in productivity (see Section VI.B, for a further discussion of earnings sharing).

experience in the respective time periods, the issue for the Department is to determine the productivity offset that best reflects the appropriate projection of productivity during the term of the price cap plan. [97]

The record in this case shows that there has been significant variability in annual TFP growth, over the past 65 years, and input price growth, over the past 30 years (see Exhs. NYNEX-3, exh. C; NYNEX-37, App. 1). It was to be expected that the average annual TFP and input price growth of the eight-year post-divestiture period varied from the long-term average. The average annual TFP and input price data from any eight-year period are almost certain to deviate from their long-term averages, but the record indicates that they have deviated in both directions and to varying degrees over several decades. In attempting to predict on the basis of past performance what the average annual TFP and input price growth

[97] It is worth noting that this attempt to predict the future under price cap regulation, while a handicap for price cap regulation when compared to competition (see n.95, supra), should not be construed as a shortcoming when compared to ROR regulation. Under traditional ROR regulation, the Department invariably must make predictions about a utility's future expenses, based on historic costs. See Boston Edison Co. v. Department of Pub. Utils. , 375 Mass. 1, 24 (1978) ("[with the test-year method] [t]he Department examines a test period -- usually the most recent twelve-month period for which complete financial information exists -- on the theory that revenue, expense, and rate base figures during that period accurately reflect the utility's present financial situation and fairly predict the Company's future performance ." (citation omitted) (emphasis added)).

for the average firm in the industry are likely to be over the term of the price cap plan, we find that it is more sound to base such a prediction on the long term averages than it would be to attempt to predict the direction and extent of the deviation from those averages.

i. Total Factor Productivity

Consistent with the analysis above regarding projections of future productivity, we find that it is more appropriate to use the long-term average TFP differential of two percent as the TFP component of the productivity offset. We find it appropriate to use a differential between average annual TFP growth of the telecommunications industry and the U.S. economy because we account for variation in input price growth with an input price differential component in the productivity offset (see, infra).

Regarding the suggestion by several intervenors that the Department should consider NYNEX's historic productivity in setting the productivity offset, a review of the evidence indicates that reliance on company-specific data would be inappropriate because (1) in a competitive market, NYNEX's prices would change at the same rate as the industry average productivity change, not at the rate of NYNEX's own productivity change; and (2) NYNEX's incentive to improve productivity would be dampened by the knowledge that future productivity offsets would be set based on the Company's own productivity. Moreover, the Company's expected productivity gains and cost reductions from its process re-engineering initiatives are accounted for in the two additional components of the productivity offset, described below. Finally, there is no statistical support for NECTA's contentions about NYNEX's expected productivity, as viewed by the investment community, and no record evidence to support its claim regarding the effect of sales growth on productivity under price regulation.

ii. Input Price Differential

The record indicates that there is a difference of 0.1 percent in input price growth over the past 30 years for the U.S. economy and the telecommunications industry (see Exh. NYNEX-3, exh. B at 5 n.3). Therefore, because we are basing our analysis for determining the proper productivity offset on the industry's long-term experience, we find there should be an input price differential of 0.1 percent in the productivity offset. We do not rely on the post-divestiture period as the basis for determining the proper input price differential because while divestiture and the concomitant advances in technology have been notable, there have been other significant changes in the industry during the past 30 years. The record in this case does not contain sufficient evidence to conclude that input price growth has been uniquely affected by divestiture. Therefore, it would be inappropriate simply to assume that the next five to ten years will result in similar input price growth as the last five to ten years, on the sole basis that both time periods are post-divestiture.

With regard to the alleged inappropriateness of Dr. Taylor's use of a statistical T-test to challenge the validity of the Attorney General's proposed input price differential, we find that such a test is appropriate because it demonstrates that use of a longer time period as a basis for projecting into the future is more sound when the subject data vary significantly, as is the case with input prices.

Since we have accounted for variation in input price growth of the telecommunications industry and the U.S. economy with an input price differential, we find, contrary to the Attorney General's argument, that under price regulation the Company likely would not be compensated at a rate higher than its actual expenses over the term of the plan.

iii. Stretch Factor

Because well-designed price cap regulation is superior to ROR regulation in promoting economic efficiency, the average annual productivity of the industry should be higher if the firms in the industry are regulated under a price cap rather than ROR. Therefore, if the productivity factor is based on the historic experience of the industry, the productivity offset for the future should be higher to compensate for this expected productivity gain. The Company recommended a consumer productivity dividend, or "stretch" factor, of 0.5 percent to represent this expected productivity increase, and the Attorney General recommended a stretch factor of one percent.

The Department agrees with the Attorney General that the stretch factor should be one percent based on the Department's finding that the average annual productivity for NYNEX under a price cap should be higher than it was under ROR.[98]

iv. Accumulated Inefficiencies

As described, supra, several parties have suggested that accumulated inefficiencies are reflected in the Company's current rates, as evidenced by the Company's current process re-engineering initiative and other downsizing programs. These parties argue that such inefficiencies should be accounted for in the productivity offset. We agree that it is likely that inefficiencies have accumulated and are contained in NYNEX's current rates. If the telecommunications industry has been operating less efficiently during the long-term period that is the foundation of the productivity offset than it would have under price cap regulation (a notion that must be acknowledged in

[98] The consumer productivity dividend can be characterized as an up-front, annual return to ratepayers of a portion of the Company's earnings. On average NYNEX will have to be at least one percent more productive than the average firm in the telecommunications industry has been over the past 65 years, in order to maintain its earnings at a constant level.

order to accept price cap regulation as superior to ROR regulation in maximizing economic efficiency), then there must be accumulated inefficiencies that should be accounted for in the first term of a price cap plan.

Since these inefficiencies have accumulated over time under the current ROR method of regulation, it is unlikely that these inefficiencies could be identified and removed from the Company's rates by conducting a full rate case. On the basis of the earnings review conducted in this case, the Department has concluded in Section VII, *infra*, that the Company's current earnings are reasonable, and, consequently, that the Company's current rates are the appropriate starting rates for the Plan. However, we find that our acceptance of the underlying rationale for approving price cap regulation, *i.e.*, that the average firm under price cap regulation will be more efficient than the average firm under ROR regulation, requires us also to find that there are accumulated inefficiencies in the Company's current operations that the Department was unable to discover in its earnings review and would be unable to discover in a traditional rate case. These inefficiencies nevertheless should be accounted for in the price cap formula. Accordingly, the Department finds that it is necessary to add an additional one percent to the productivity offset, in order to account for accumulated inefficiencies.[99]

v. Summary

For the above reasons, the Department approves a productivity offset of 4.1 percent for NYNEX's price cap, consisting of (1) a two percent productivity factor, (2) an input price differential of 0.1 percent, (3) a one percent stretch factor, and (4) an additional one percent to account for accumulated inefficiencies. We have established a productivity offset that is higher than the productivity that the average telecommunications company has achieved on an average annual basis in the past 65 years. Thus, ratepayers will benefit from adoption of this price cap because NYNEX's aggregate rates under this price cap plan are likely to be lower over the term of the plan than they would be under ROR regulation. Nevertheless, our approved productivity offset represents an achievable level of efficiency growth for NYNEX and offers it a reasonable opportunity for above-average returns resulting from above-average performance. In addition, because the fixed productivity offset is greater than the historic average productivity growth of the telecommunications industry, it creates a tangible benefit for ratepayers under price cap

[99] After the Company has been operating under price cap regulation for the first six-year term (see Section VI.F), we expect that the weeding out of accumulated inefficiencies would be completed, and future productivity offsets may be adjusted downward to compensate.

regulation that would not exist under ROR regulation.

3. Exogenous Costs

Under the Company's proposed Plan, exogenous cost changes are defined as those that represent changes in cost to the firm that are not captured by changes in conventional inputs and that are beyond the firm's control (Exh. NYNEX-3, at 21). In the Attorney General's proposed price cap, exogenous events are defined as those outside the control of the LEC that can directly affect its costs and/or its performance. He argues that exogenous events included in the Z adjustment should be limited to cost shifts between state and federal jurisdictions, and certain limited tax changes (Attorney General Brief, Part I, at 63).

a. Positions of the Parties

i. NYNEX

The Company concludes that its definition of exogenous cost changes, represented as the Z factor in the price cap formula, is reasonable (NYNEX Brief at 53). The Company defines an exogenous cost change as any change in cost, either positive or negative, to the firm that is (1) not captured by changes in conventional inputs, and (2) beyond the firm's control (id., citing Exh. NYNEX-3, at 21). The Company argues that since exogenous cost changes are not reflected in the GDP-PI, it should be permitted to make those additional adjustments in rates under the

Plan, in order to account for these cost changes (id. at 53).

The Company's witness, Dr. Taylor, proposes that exogenous cost changes under the Plan be treated as they would in a competitive market, i.e., the Company would flow them directly through to ratepayers through the Z adjustment in the price cap formula (id.). NYNEX argues that, as these exogenous costs are defined as being beyond the Company's control, they would not affect the Company's incentives (id., citing Exh. NYNEX-3, at 21).

The Company identifies the following examples of exogenous cost changes: changes in regulatory definitions and allocations of costs to services; changes defined by governmental accounting standards boards; changes in tax laws or rates; and regulatory, judicial, or legislative changes affecting costs (id. at 54 n.17, citing Exh. NYNEX-3, at 22). The Company argues that its definition of exogenous costs mirrors the FCC's and that the Attorney General's definition of Z adjustments is too narrow and should be rejected (id. at 55).

ii. Attorney General

The Attorney General defines exogenous events as those outside the control of the LEC that can directly affect its costs and/or its performance, and argues that exogenous events included in the Z adjustment should be limited to cost shifts between state and federal jurisdictions, and limited tax changes

(Attorney General Brief, Part I, at 63). The Attorney General argues that the only time costs associated with one-time exogenous events should be included in the Z adjustment is when they result from conditions uniquely applicable to regulated LECs (id. at 64, citing Exh. AG-795, at 95, Figure 8).

The Attorney General disagrees with the Company's Z adjustment proposal because, according to the Attorney General, it allows for exogenous events that affect non-LEC companies as well as LECs (id. at 65). According to the Attorney General, this approach would require a separate and potentially burdensome calculation to avoid double counting cost changes also reflected in the GDP-PI (id.).

The Attorney General states that nonregulated businesses have to learn to prepare for and handle contingencies that may affect their costs, and that in many instances they cannot recover those costs (id. at 64). Therefore, the Attorney General argues that cost changes that are reflected to some degree in the GDP-PI and that may have a disproportionate impact on LECs should not be included in the Z adjustment (id. at 65).

The Attorney General argues that, in theory, exogenous cost changes can have either a positive or negative effect on LEC rates, but that LECs have a bias to identify positive Z adjustments, and interested parties would not have the inside knowledge or economic incentive to research and identify negative

Z adjustments (id. at 66-67). According to the Attorney General, the Department therefore should define the Z adjustments "narrowly and carefully" (id. at 67). The Attorney General also argues that his proposed Z factor is less administratively burdensome (id.). The Attorney General concludes that the Department should adopt his definition of the appropriate Z factor, which is limited to adjustments to regulatory separations cost changes and limited regulatory accounting changes (id.).

iii. AT&T

AT&T argues that the Department should reject the Company's proposal that exogenous cost changes should be determined depending on whether they result from measures voluntarily adopted by the Company (thereby not exogenous), or from externally mandated measures (thereby treated as exogenous) (AT&T Brief at 57, App. B at 5). According to AT&T, this voluntary-involuntary dichotomy will result in disincentives for the Company to adopt voluntary measures needed to enhance the development of competition in Massachusetts (id., App. B at 5).

b. Analysis and Findings

Of those parties that have endorsed adoption of price cap regulation for NYNEX, all agree that the price cap formula should account for exogenous costs; the disagreement primarily is over the definition of exogenous costs. As noted earlier, the price cap formula is intended to represent the expected change in costs for the average firm, but exogenous costs are not otherwise accounted for in the price cap formula. Therefore, we find that an exogenous cost component is necessary to reflect those costs that are not otherwise accounted for in the price cap formula.

We find the Attorney General's definition of exogenous costs is drawn too narrowly and would unfairly exclude legitimate exogenous cost changes. Contrary to the Attorney General's suggestion, in a competitive market these costs eventually will be passed along to customers as higher rates. We find that exogenous costs should be defined as positive or negative cost changes actually beyond the Company's control and not reflected in the GDP-PI, including, but not limited to cost changes resulting from:

- changes in tax laws that uniquely affect the telecommunications industry;
- mandated jurisdictional separation changes;
- accounting changes unique to the telecommunications industry; and
- regulatory, judicial, or legislative changes uniquely affecting the telecommunications industry.

We find that if a dispute arises as to the propriety of an exogenous cost, the proponent of the exogenous cost adjustment will bear the burden of proof. In addition, to avoid double counting, the proponent of the exogenous cost adjustment bears the burden of demonstrating that the proposed exogenous cost change has not been reflected in the GDP-PI.

Also, we find that there should be a threshold for qualification as an exogenous cost in order to avoid regulatory battles about minimal dollar amounts. We find that any proposed exogenous cost adjustment must affect the Company's annual revenues by at least $3 million. [100] Finally, the financial effect of any proposed exogenous cost change should be quantified and explained in detail by the party proposing the adjustment, in order to minimize the number and extent of disputes.

B. Earnings Sharing

Under the Plan, NYNEX would not be subject to ROR regulation and would be exempt from challenges to, or review of, its earnings based on principles of ROR regulation for the period of the price cap plan (Exh. NYNEX-1, at 24).

In the Attorney General's proposed price cap plan, if the Department determines that the Company's ROR is in excess of 50 basis points above the Department-approved base rate of return ("BROR"), the Company should share that excess on a 50/50 basis with ratepayers, and if the Department determines that the ROR is in excess of 500 basis points above the BROR, all earnings in excess of 500 basis points above the BROR should be credited to

[100] See Illinois Bell Telephone Company, 92-0448/93-0239 Consol., at 62 (Ill. Commerce Comm'n 1994), 156 P.U.R. 4th 121 (1994) (The Illinois Commission limits proposals for exogenous cost treatment to items equal to or greater than $3 million). The level of Illinois Bell's intrastate revenues is similar to the Company's.

ratepayers (Exh. AG-796, at 6). If the Company's ROR for any two consecutive years falls below the BROR minus 325 basis points, then the Company may petition the Department to terminate the price cap regulation plan and revert to traditional rate base regulation (id.). The Company may simultaneously petition for an emergency rate increase upon a showing that the earnings deficiency was sudden and unexpected (id. at 6-7).

1. Positions of the Parties

a. NYNEX

The Company argues that it is not appropriate to include an earnings sharing mechanism in a price cap formula because such mechanisms have a detrimental impact on the positive incentives inherent in price cap regulation (NYNEX Brief, App. B at 14). NYNEX maintains that an earnings sharing mechanism is not necessary to ensure that customers benefit under price cap regulation because customers would benefit from lower real prices resulting from the productivity offset adjustment (id.). NYNEX asserts that the balancing of the interests of the Company and ratepayers that is contained in the Plan should not be altered by an earnings sharing mechanism (id. at 101). NYNEX contends earnings sharing is an inferior regulatory tool that would "impair and severely handicap the Company's ability" to realize the economic incentives contained in the Plan (id.). NYNEX states that earnings sharing mechanisms were used in the early stages of incentive regulation as an additional precaution against improperly chosen productivity targets (id.). NYNEX maintains that the need for this precaution is outweighed by the disadvantage of "diluting the economic incentives to the Company" under the Plan (id., citing Exh. NYNEX-3, at 12).

NYNEX acknowledges that earnings sharing is a component of the FCC's price cap plan for LECs, but asserts that at the time the FCC devised its price cap, there was little experience with price cap plans nationwide (id. at 103). NYNEX states that the FCC recognized that using earnings sharing "[a]s a backstop mechanism may dampen the LECs' risks and rewards and thus reduce the incentives of a `pure' price cap plan" (id., citing Second Report and Order , 5 FCC Rcd. 6786, ¶121 (1990)).

In addition, NYNEX argues that the Attorney General's proposed earnings sharing mechanism is more narrow and rigid than that applied by the FCC and more severe than those adopted by other state utility commissions (id. at 104). NYNEX contrasts the Attorney General's proposal to a plan adopted in California (id.). In the California plan, the company is allowed to keep all of its earnings up to the 11.5 percent BROR, and earnings sharing occurs on a 50/50 basis from 11.5 to 15.0 percent (id. at 104-105; Re Pacific Bell , 153 P.U.R. 4th 65 (1994)). NYNEX further states that in the California plan, the company is also allowed to retain 70 percent and share 30 percent of earnings over 15.0 percent (id. at 105). NYNEX asserts that the California plan is less stringent than the 50 basis point deadband proposed by the Attorney General in this proceeding as a trigger for 50/50 earnings sharing (id.). Also, according to NYNEX, the California plan allows a company to seek relief if earnings fall below 6.75 percent at any time, while under the Attorney General's Plan, NYNEX would only be able to seek relief if earnings fall below 7.45 percent for two consecutive years (id.).

Responding to the Attorney General's argument that earnings sharing is required as a matter of law to ensure just and reasonable rates and reasonable compensation for services rendered, the Company argues that such a mechanism is not required to comply with G.L. c. 159, § 20 (NYNEX Reply Brief at 8-9). NYNEX maintains that a price cap formula based on historical productivity factors, coupled with the Company's proposed cap on basic residential rates, "adequately ensures just and reasonable rates for the future and reasonable compensation under the law" (id. at 9).

Addressing questions raised regarding whether earnings sharing constitutes retroactive ratemaking, NYNEX maintains that there is no Massachusetts precedent on whether earnings sharing constitutes retroactive ratemaking, and, therefore, a judicial challenge would be a matter of first impression (NYNEX Brief, App. B at 15).

Finally, NYNEX maintains that the Attorney General's earnings sharing mechanism would penalize it for efficiency gains and would prohibit the Company from seeking relief until earnings have been "significantly eroded" (NYNEX Brief at 105). Accordingly, NYNEX argues that the Department should reject the earnings sharing mechanism contained in the Attorney General's Plan (id.).

b. Attorney General

The Attorney General contends that an earnings sharing mechanism must be implemented in any incentive plan adopted by the Department (Attorney General Brief, Part I, at 20, citing Exh. AG-795, at 51-56, 106-109). The Attorney General asserts that such a mechanism is needed to ensure that ratepayers participate in the efficiency gains of the Company under price cap regulation and to safeguard against the possibility of NYNEX earning excess profits (id.).

The Attorney General contends that earnings sharing does not constitute retroactive ratemaking (id. at 83). The Attorney General argues that his plan contains no refunds or surcharges and that his earnings sharing mechanism has fewer retroactive aspects than a plan previously approved by the Department (id., citing Boston Edison Company, D.P.U. 92-92 (1992).[101]

[101] In D.P.U. 92-92, the Department approved a settlement agreement that provides, inter alia, for refunds of earnings above an ROR on common equity of 11.75 percent, before any penalties are paid or incentives are received for performance

The Attorney General alleges that earnings sharing is required by the G.L. c. 159, § 20 "just and reasonable" ratemaking standard (Attorney General Brief, Part I, at 80-82).[102] He argues that Massachusetts' statutory scheme requires that rates may not yield more than "a fair and reasonable return on honestly and prudently invested capital" (id. at 79, quoting Boston Gas Co. v. Department of Pub. Utils., 367 Mass. 92, 97 (1975); Lowell Gas Co. v. Department of Pub. Utils., 324 Mass. 80, 94 (1949)).[103] The Attorney General maintains that "[r]ates [that] are either too low or too high, judged by this standard, are unjust and unreasonable, either to the company and its stockholders or to the ... public" (id. at 79-80 & n.42, citing Railroad Passenger Rate Case, 8d Ann. Rep. Mass. P.S.C. 3 (1915);

[101] (...continued) goals.

[102] The Attorney General contends that the primary purpose of utility regulation is the protection of ratepayers from "exorbitant rates" (Attorney General Brief, Part I, at 78, quoting Washington Gas Light Co. v. Baker, 188 F.2d 11, 15 (1950); and citing New England Tel. and Tel. Co. v. Department of Pub. Util., 371 Mass. 67, 84 (1976), Smith v. Ames, 169 U.S. 466, 547 (1898), Covington & L. Turnpike Road Co. v. Sanford, 164 U.S. 578, 596 (1896)).

[103] The Attorney General states that "[a] return is fair and reasonable if its covers utility operating expenses, debt service, and dividends, if it is sufficient to attract capital and assure confidence in the enterprise's financial integrity" (Attorney General Brief, Part I, at 79, quoting Fitchburg Gas & Elec. Light Co. v. Department of Pub. Utils., 371 Mass. 881, 884 (1977); Federal Power Comm. v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944)).

and quoting Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989) ("[W]hether a particular rate is `unjust' or `unreasonable' will depend to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return."). According to the Attorney General, NYNEX is not entitled to a return of a "highly profitable enterprise[] or speculative venture[]" (id. at 81, quoting Bluefield Waterworks & Improvement Co. v. Public Serv. Comm., 262 U.S. 679, 692-693 (1923); and citing Boston Edison Company, D.P.U. 906, at 210 (1982); Appeal of Public Serv. Co. of New Hampshire, 547 A.2d 269 (N.H. 1988)). Finally, the Attorney General argues that NYNEX's rates under a price cap plan must be within a "zone of reasonableness" and the Plan cannot "break[] the nexus between ... capital invested and the return thereon" (id. at 80-82, citing Federal Power Comm. v. Natural Gas Pipeline, 315 U.S. 575, 585-586 (1942)).

In light of the above-cited precedent, the Attorney General contends that earnings sharing or an earnings cap is a necessary component of any price cap plan adopted by the Department because a price adjustment mechanism alone will not ensure that NYNEX earns only a fair return on investment (id. at 80-81, citing New England Tel. & Tel. Co. v. Department of Pub. Utils., 371 Mass. 67, 73). The Attorney General claims that the earnings sharing and earnings cap mechanisms that he has proposed would allow NYNEX to satisfy the statutory requirement by preventing the "accumulat[ion] [of] excess profits through exorbitant prices" (id. at 87). He argues that these mechanisms "provide[] an appropriate balancing of consumer and investor interests and ensure that the return to investors falls within the `zone of reasonableness'" (id. at 82).

The Attorney General also claims that his earnings sharing mechanism, as contrasted with the Company's proposal for no earnings sharing, would reduce the administrative burden for the Department and parties (id. at 84-85). He asserts that the Company's earnings report filing could be streamlined (id. at 85). The Attorney General contends that without earnings sharing, the potential for disputes over whether the Company is earning reasonable compensation will increase dramatically (id. at 85-86). However, if the Department adopts the Attorney General's earnings sharing mechanism, which is designed to "reduce the potential for NET's [sic] to accumulate excess profits through exorbitant prices," the Department could minimize the potential for parties to appeal this Order as well for parties to file future complaints (id. at 86).

Finally, the Attorney General claims that earnings sharing and an earnings cap are necessary because the productivity adjustment, particularly the consumer dividend portion of the

X-factor, does not ensure that ratepayers will benefit from the Company's expected improved productivity (id.).

c. AT&T

AT&T maintains that an earnings sharing mechanism does not constitute retroactive ratemaking and that it is needed to prevent NYNEX from collecting monopoly profits with no benefit flowing to ratepayers (AT&T Brief at 53, App. B at 6; AT&T Reply Brief at 20). AT&T also states that any earnings sharing mechanism should include an appropriate band around a benchmark rate of return (AT&T Brief at 53). AT&T suggests that a six percent band would be appropriate, allowing for three percent above and below the BROR (id.).

AT&T further states that if an earnings sharing mechanism is implemented, it is necessary that NYNEX be precluded from changing depreciation rates without prior Department approval (id.). AT&T states that if NYNEX is not so precluded, it would have the ability to adjust its depreciation rates to impact its earnings -- thereby defeating the purpose of an earnings sharing mechanism (id.). Finally, AT&T states that earnings sharing is needed to balance the incentives for NYNEX to increase efficiencies and thereby increase profits, while protecting ratepayers from monopoly abuses (id.).

d. MCI

MCI supports the Attorney General's Plan, which contains an earnings sharing mechanism, and does not consider earnings sharing to be retroactive ratemaking (MCI Brief at 31, 37). MCI argues that because of the lack of an earnings sharing mechanism, NYNEX's Plan would not require sharing of excess earnings with its ratepayers (id. at 31). MCI notes that NYNEX projects that its process re-engineering plan will substantially reduce its operating costs, yet does not ensure that its monopoly customers will benefit from its efficiency gains (id.). MCI further states that as a result of the lack of a sharing mechanism, the "insufficient" productivity factor, and the absence of a cap on earnings, NYNEX's Plan guarantees that NYNEX will be able to retain all of its excess earnings without refunding anything to its ratepayers (id.).

MCI contends that if NYNEX is allowed to keep its excess earnings, it would have a huge fund from which to finance its competitive ventures (id. at 31-32). Finally, MCI recommends that no price cap plan should be adopted by the Department for NYNEX without an appropriate earnings sharing mechanism (id. at 32).

e. NECTA

NECTA argues that if an alternative regulation plan is adopted by the Department, the Attorney General's Plan is preferable to the Company's Plan (NECTA Brief at 13). NECTA states that if the Department decides that earnings sharing constitutes retroactive ratemaking, then it must retain existing regulation (id.). Finally, regarding the question of retroactive ratemaking, NECTA asserted that even if a prospective reduction in rates based upon past overearnings does not constitute retroactive ratemaking, it would be prudent for the Department to await enabling legislation before adopting a form of price regulation that contains an earnings sharing component (NECTA Reply Brief at 5).

NECTA agrees with the Attorney General that the lack of a ceiling on earnings under the Company's Plan is a "fatal legal flaw" (NECTA Brief at 9). [104] NECTA argues that G.L. c. 159, §§ 14 and 20 require earnings sharing or an earnings cap, in that those statutes mandate a link between the Company's costs and its earnings (id. at 33-47). NECTA maintains that the legislature requires a "nexus between [NYNEX's] revenue requirement and any maximum allowable rates," to protect customers from excessive rates (id. at 40). NECTA contends that the "express language" of G.L. c. 159, §§ 14 and 20 and the overall legislative scheme of Chapter 159 create a "zone of reasonableness" standard, the upper and lower boundaries of which are a "cost-based ceiling and cost-based floor" (id. at 38). According to NECTA, the requirement of a "cost-based ceiling" or "cost-based floor"

[104] For a detailed description of NECTA's positions on these issues, see February 2, 1995 Interlocutory Order at 5-10.

exists in the specific language of G.L. c. 159, §§ 14 and 20, in the overall statutory scheme, and as a matter of constitutional law to prevent confiscation (id. at 35). NECTA points to the Settlement Agreement approved by the Rhode Island Public Utilities Commission, which includes a cap on NYNEX's earnings in the price regulation component (id. at 41). NECTA also notes that the FCC price cap plan for AT&T, unlike the NYNEX Plan, maintains a nexus between carriers' rates, costs, and earnings (id. at 43).

f. FEA

FEA recommends that an earnings sharing mechanism be implemented if the Department decides to abandon traditional ROR regulation for NYNEX (FEA Brief at 12). FEA contends that an earnings sharing mechanism would allow NYNEX's stockholders and ratepayers to share in the earnings of the Company (id. at 12-13). FEA argues that earnings regulation is the best procedure for identifying and controlling monopoly profits, and thereby protecting captive customers (id. at 11). FEA states that earnings sharing provides an additional "backstop" to errors in setting the productivity factor (id. at 12).

FEA gives several examples of earnings sharing plans and indicates that other commissions have earnings sharing regulations for similarly situated telephone companies (id. at 13). FEA refers to the FCC, which employs earnings sharing for the interstate operations of NYNEX and other large carriers under its jurisdiction (id.). FEA points to approximately 20 other states that, as of June 1993, have earnings sharing as a component of incentive regulation for the principal telephone companies under their jurisdiction (id.). FEA notes that several of these jurisdictions, including the FCC, have combinations of price regulation and earnings sharing, which is what FEA recommends for NYNEX in Massachusetts (id.).

g. NELF

NELF disagrees with the Attorney General's contention that an earnings sharing mechanism is required to enable the Department to comply with the statutory mandate to ensure that prices are just and reasonable (NELF Reply Brief at 4). NELF contends that the Attorney General fails to realize that inherent in any regulatory model that sets prices is the possibility that the regulated company may do better or worse than anticipated (id.).

According to NELF, the Massachusetts Supreme Judicial Court rejected claims that rates set by a regulatory body were inadequate because, in prior years, such rates resulted in losses (id., citing Massachusetts Automobile Rating Bureau v. Commissioner of Insurance, 384 Mass. 333, 374 (1981)). According to NELF, the Court did this because any future rate decision must be based on a reasonable prediction of what will occur, not whether the decision retrospectively guarantees a predetermined result (id.).

NELF asserts that if an earnings sharing mechanism is implemented, intellectual consistency would suggest a loss sharing provision to balance the risk of unanticipated losses (id.). According to NELF, unlike AT&T, which proposes an "earnings floor" to allow relief for NYNEX if earnings drop too low, the Attorney General suggests that NYNEX shareholders share unanticipated gains but be responsible for all unanticipated losses (id.).

2. Analysis and Findings

Several parties have raised the issue of the Department's statutory authority to approve a price cap that does not include earnings sharing and/or a cap on earnings. [105] In the February 2, 1995 Interlocutory Order denying NECTA's Motion to Dismiss, the Department stated that, only for purposes of ruling on the Motion to Dismiss, "we would accept the Company's assertion that the NYNEX Plan contains an adequate constraint on earnings, if one is

[105] Earnings sharing refers to a sharing of above-average profits between the utility and ratepayers, whereas an earnings cap refers to a ceiling that defines the maximum return that a utility could earn. Under earnings sharing, the regulator sets a benchmark return, using traditional ROR techniques, and establishes the level(s) of return above the benchmark at which sharing would be triggered, and the distribution of those above-average earnings between the utility and ratepayers. With an earnings cap, all above-average earnings that exceed the cap go to ratepayers.

indeed necessary in order for a price cap to be lawfully established." February 2, 1995 Interlocutory Order at 63-64 (emphasis added). Thus, the Department deferred ruling on the question of whether an earnings cap or earnings sharing is legally required. We now address that legal question and, for the reasons cited below, find that an earnings cap or earnings sharing is not required by law.[106] Later in this section we address the policy questions related to earnings sharing.

As the Department noted in the February 2, 1995 Interlocutory Order, "the plain language of G.L. c. 159, §§ 14 and 20" prescribes that rates must be "just and reasonable" and that rates provide a carrier "reasonable compensation" for the services provided. February 2, 1995 Interlocutory Order at 37, 63; see also G.L. c. 159, § 17 ("All charges made ... by any common carrier for any service rendered or performed ... shall be

[106] This is an issue of first impression for the Department. To our knowledge, it has never been addressed by Massachusetts courts, in the context of utility ratemaking. See NELF reference to relevant insurance industry case law, supra. In addition, it appears that other state and federal courts have not yet addressed this specific question. In the area of economic regulation, the starting point on any inquiry is always what the legislature, subject to constitutional constraints, has expressly determined to be required or permissible. In default of any such clear expression, the starting point is what the agency charged with such regulation has statutory discretion to require or permit.

The search for relevant judicial precedent is an important feature of any inquiry in public utility law, but the absence of precedent cannot stymie a regulatory agency in construing its legislative mandate.

just and reasonable, and ... every unjust or unreasonable charge is hereby prohibited and declared unlawful ...." [107] Section 14 also prohibits rates that are "unjustly discriminatory, unduly preferential, [or] in any wise in violation of any provision of law." G.L. c. 159, § 14. Thus, there are no explicit words in Sections 14, 17, or 20 that cap a utility's profits at a certain level, other than the language that rates must be sufficient to yield reasonable compensation.

Certainly, implicit in the Department's ratemaking authority under G.L. c. 159 is the protection of customers from "the abuses of monopoly." Weld v. Gas & Elec. Light Comm'rs, 197 Mass. 556, 558 (1908) ("The State, through the regularly constituted authorities, has taken complete control of these corporations so far as is necessary to prevent the abuses of monopoly." [emphasis added]); see also Incentive Regulation, D.P.U. 94-158, at 3 (1995) ("Since the time of its establishment by the Massachusetts Legislature in 1919, the goal of the Department has been to ensure that the public utility companies it regulates provide safe, reliable, and least-cost service to Massachusetts consumers."). Thus, one of the primary purposes for regulating

[107] Section 20 also gives the Department the authority, when a carrier proposes a reduction in a rate that is insufficient to yield reasonable compensation for the service provided, to establish a "just and reasonable minimum." G.L. c. 159, § 20.

utility rates is to guard against, or limit, monopoly profits.[108]

As the courts have found, "just and reasonable" ratemaking involves a balancing of the public (or consumer) interests, in being charged reasonable rates for service, and the interests of utility investors, in being fairly compensated for use of their capital. See Donham v. Public Serv. Comm'rs, 232 Mass. 309, 326 (1919) ("the public service commissioners may make such changes therein as in its judgment are required by the public interests and the rights of the owners of invested capital"); Cambridge Elec. Light Co. v. Department of Pub. Utils., 333 Mass. 536, 539 (1956) ("[R]ates are regulated and may be expected to be generally fair in the future but not oppressive to the consumer."); Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) ("the fixing of `just and reasonable' rates, involves a balancing of the investor and [the] consumer interests"). In balancing the competing interests of consumers and utility investors, regulators must determine what is "reasonable compensation," that will lead to just and reasonable rates.

Under ROR regulation, "reasonable compensation" has been defined by the Massachusetts Supreme Judicial Court ("the Court")

[108] In theory, utilities, as natural monopolies, have had little or no effective competition to keep prices at reasonable levels. Regulation is employed to limit the ability of utilities to raise prices, and thereby increase profits, at the expense of captive customers.

to mean "sufficient to yield a fair return on the reasonable value of the property used or invested for doing the business after paying costs and carrying charges." *New England Tel. & Tel. Co. v. Department of Pub. Utils.*, 331 Mass 604, 615 (1954); *see also* *New England Tel. & Tel. Co. v. Department of Pub. Utils.*, 371 Mass. 67, 73 (1976) (holding that utility be given "the opportunity to earn a ` *fair and reasonable return* on honestly and prudently invested capital'" (emphasis added), *citing* *Boston Gas Co. v. Department of Pub. Util.*, 367 Mass. 92, 97 (1975) ("... the Company is entitled to charge rates which afford it the opportunity to meet its cost of service, including a fair and reasonable return on honestly and prudently invested capital ..."); *Boston Edison Co. v. Department of Pub. Utils.*, 375 Mass. 1, 10 (1978), *cert. denied*, 439 U.S. 921 (1978), *citing* *Boston Gas Co. v. Department of Pub. Utils.*, 368 Mass. 780, 789-790 (1975); *Massachusetts Elec. Co. v. Department of Pub. Utils.*, 376 Mass. 294, 299 (1978). "A return is fair and reasonable if it covers utility operating expenses, debt service, and dividends, if it compensates investors for the risks of investment, and if it is sufficient to attract capital and assure confidence in the enterprise's financial integrity." *Massachusetts Elec. Co. v. Department of Pub. Utils.*, 376 Mass. at 299, *citing* *Fitchburg Gas & Elec. Light Co. v. Department of Pub. Utils.*, 371 Mass. 881, 884 & n.5 (1977) (in *Fitchburg*, the

Court noted that, "`[r]eturn' in this sense describes utility revenue requirements including operating expenses and capital costs. The Department computes a utility's revenue requirements through valuation of the utility's rate base and establishment of a rate of return which is then applied to the rate base. Together these computations yield a return on investment.").[109] "The return on equity `should be commensurate with returns on investments in other enterprises having corresponding risks.' In addition, the rate of return on equity `should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital;" Massachusetts Elec. Co. v. Department of Pub. Utils., 376 Mass. at 300, citing Federal Power Commission v. Hope Natural Gas Co., 320 U.S. at 603; Boston Edison Co. v. Department of Pub. Utils., 375 Mass. at 12, 13-14..

[109] Confiscation, on the other hand, is defined as depriving "a utility of the opportunity to realize a fair and reasonable return on its investment." Boston Edison Co. v. Department of Pub. Utils., 375 Mass. at 10; see also U.S. Const. amends. V and XIV ("[N]or shall private property be taken for public use, without just compensation"); Mass. Const. Pt. 1, Art. 10 ("And whenever the public exigencies require that the property of any individual should be appropriated to public uses, he shall receive a reasonable compensation therefor."); Duquesne Light Co. v. Barasch, 488 U.S. at 308 ("If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments."). If, by its so-called "cost-based floor," NECTA is suggesting that by law there is a minimum return that regulators must give a utility the opportunity to earn to avoid confiscation, we agree.

The question of what constitutes a fair return (or reasonable compensation), pursuant to Sections 14 and 20 of Chapter 159, under an incentive regulatory scheme, such as price cap regulation, has not been addressed by the Court. In arguing that NYNEX, under price cap regulation, can be allowed no more than a "fair return on its investment," the Attorney General mistakenly applies the ROR definition of a fair return (i.e., a return that covers a utility's operating expenses, debt service, and dividends, and is sufficient to attract capital and assure confidence in the enterprise's financial integrity) to incentive regulation.[110]

[110] Under the "fair return" standard advocated by the Attorney General, even his proposed earnings sharing plan would not pass statutory muster, since NYNEX could keep earnings of 50 basis points above its allowed rate of return. Moreover, if, as NECTA contends, Chapter 159 placed a "cost-based ceiling" on the return that NYNEX could earn, then by law the Department would be prohibited from approving any incentive regulation plan that allowed the Company the opportunity to earn a return that exceeds its costs, regardless of whether the plan itself contained a cap on earnings or earnings sharing. The prohibition would be absolute. Earnings sharing or an earnings cap would not cure the unlawfulness of the scheme. Such an interpretation of the statutes also would seem to call into question the Department's use of the ROR convention of regulatory lag, or other profit incentives that have been employed under ROR regulation. Regulatory lag, whereby a utility has the opportunity to increase its profits in the short term by improving productivity between rate cases, has always been an accepted and even useful feature of ROR regulation. See D.P.U. 94-158, at 55-56. Moreover, the Department in the past has relied on adjustments to the allowed return on equity, under ROR regulation, as a means to reward efficiency and penalize utilities for inefficient operations. Id. at 56, citing

(continued...)

Any definition of reasonable compensation under an incentive regulatory scheme must be broad enough to allow a utility that is achieving above-average efficiencies to earn more than has been defined as a "fair return" under ROR regulation. In this sense, a reasonable return under ROR regulation is not the same as what would be considered a reasonable return under price cap regulation. In our view, a fair return under an incentive regulation plan is defined as the firm's true cost of capital, plus earnings derived from above-average productivity growth, or minus earnings lost due to below-average productivity growth. As we have elsewhere stated, "[i]ncentive regulation recognizes the legitimacy of profit as an important motivator for utilities, and a utility that knows it will be rewarded for efficiency and penalized for inefficient operations will take a more aggressive approach to control costs." D.P.U. 94-158, at 55. Nothing in our statutes precludes harnessing incentives to improve service and profitability. The statutes are flexible enough to allow for utilities to earn increased profits within the context of a regulatory scheme that will produce substantial benefits for ratepayers, most importantly lower rates than would be the case

[110] (...continued)
Massachusetts Electric Company, D.P.U. 92-78, at 115 (1992); Boston Edison Company, D.P.U. 85-266/271, at 172-173 (1986). Thus, even under ROR regulation, utilities can in some circumstances earn a return that is greater than their allowed return.

under ROR regulation (see Section V.A.2.b.i).

Under the price cap plan we approve for NYNEX in this Order, NYNEX's overall rates are tied directly to the cost of providing service, both industry-wide and, potentially, firm-specific exogenous costs, as a result of the X and Z factors, respectively.[111] As we find in Section VII, infra, the Company's current rates are reasonable, and, because those rates were derived by traditional ROR standards, they are cost-based. Any future changes in those aggregate rates will be done according to the price cap mechanism, which accounts for changes in the cost of providing services. See Section V.A.2.b.i, supra (these changes are tied to general industry or economy-wide cost changes, and firm-specific cost changes outside of the firm's

[111] As the FCC noted with regard to AT&T's price cap:

> [T]he initial caps are based upon existing rates that have been filed and reviewed, and have gone into effect pursuant to our existing rate-of-return regulatory scheme. Second, the plan's adjustment formula accounts for changes both in individual firm costs, and in economy-wide and industry-wide costs ....

Further Notice of Proposed Rulemaking , 3 FCC Rcd 3195, at 3299 (1988).

According to the FCC, "[t]his reliance upon historical industry productivity data and inflation data to account for carrier costs is analogous to the Federal Power Commission's use of area-wide average natural gas producer costs in ratemaking, which the Supreme Court upheld in Permian Basin Rate Cases [390 U.S. 747 (1968)]." Id. at 3299, n.360.

control are reflected through the exogenous cost factor, or Z factor).[112]

Unlike ROR regulation, where a higher return will increase the Company's revenue requirement and its rates, NYNEX's ability to increase its profits under price cap regulation is linked to productivity increases, and will not affect the level of aggregate or individual rates. See Section V.A.2.b.i, supra. Under price cap regulation, firms that are more productive than the average will earn above-average profits. Stated another way, above-average performance leads to above-average profits. But if NYNEX's productivity falls below the average, it will earn below-average returns, in contrast to ROR regulation, where poor

[112] The Attorney General also argues that NYNEX is not entitled to a return of a "highly profitable enterprise[] or speculative venture[]" (Attorney General Brief, Part I, at 81, quoting Bluefield Waterworks & Improvement Co. v. Public Serv. Comm., 262 U.S. 679, 692-693 (1923); Appeal of Public Serv. Co. of New Hampshire, 547 A.2d 269 (N.H. 1988)). The Attorney General misapplies these cases to the issue at hand. These cases dealt with the question of confiscation under ROR regulation, not whether a regulator has the authority in considering incentive regulation to allow a utility the opportunity to earn an above-average return. Moreover, given the productivity offset that we approve for NYNEX in this Order, NYNEX must increase its productivity more than two percent over the long-term industry average in order to achieve any increase in its earnings each year. That, we believe, is a significant challenge for the Company. If it fails to double productivity over the industry average, it will earn a return equal to or less than ROR levels. If the Company's productivity decreases, its return will decrease, a result generally absent from ROR regulation. In this sense, while the potential rewards are greater under NYNEX's price cap plan, so are the risks, as compared with ROR regulation.

performance may not result in a decrease in the Company's return. This de-linking of profits and rates under price cap regulation, as distinct from traditional ROR regulation, is the principal reason that price cap regulation can and will produce in this case just and reasonable rates, even if NYNEX should earn more than it would under ROR regulation. [113] Therefore, we find that above-average profits derived from productivity gains will satisfy the reasonable compensation requirement of the statutes.

Moreover, contrary to the arguments of intervenors, such profits are not monopoly rents. [114] If a firm operating under a

[113] As the FCC noted in approving for AT&T a price cap plan that did not contain earnings sharing or a cap on earnings:

> Notwithstanding that our price cap system continues to monitor and consider profit levels to ensure they are not excessive in light of costs, it is also a system designed to permit greater earnings flexibility than a strict rate of return regime. This design is based upon the fundamental premise underlying incentive regulation and the benefits it will produce for ratepayers -- that is the potential to increase earnings that drives companies to improve efficiency. Stated another way, we believe that rates resulting in somewhat higher profits may remain just and reasonable in the context of a regulatory regime that encourages carriers to become more efficient and to lower costs, with consumer benefits assured in the form of lower rates than would not otherwise have been achieved. We believe this approach to rate regulation is fully consistent with our statutory mandate to ensure just and reasonable rates.

Report and Order, 4 FCC Rcd. 2873, at 3299-3300 (1989); see 47 U.S.C. § 201 (just and reasonable rates standard).

(continued...)

price cap earns more than what would have been defined as a reasonable return under ROR regulation, those earnings can only arise from increased productivity gains. [115] They will not be derived from the firm's position as a monopolist because the firm is not free to raise its prices apart from allowed adjustments under the price cap formula. Allowing the regulated monopoly to increase its earnings due to above-average gains in productivity mimics the competitive outcome because a firm that achieves

[114] (...continued)

[114] As the FCC noted with regard to AT&T's price cap, "any ratemaking methodology that utilizes costs that are not firm-specific necessarily allows carriers to improve profits by reducing their costs below the benchmark set by the regulator." Report and Order , 4 FCC Rcd at 3299, n.1839. Moreover, as we noted earlier in discussing regulatory lag, utilities can improve their profits in much the same way under ROR regulation. See Cities of Abilene v. Public Utility Commission of Texas , 854 S.W. 2nd 932 (1993). In that case, the Court stated:

> In a conventional rate case there is no consideration of future changes in the actual rate of return. If consumer use exceeds projections or operationAL costs are reduced to create a greater return from the set rates, the utility retains the entire windfall until the next rate case adjusts the rate of return and individual rates. The potential of future events which may result in a return greater than the reasonable rate of return does not make the finding of the reasonable rate of return erroneous or unsupported by evidence.

Id. at 940.

[115] Dr. Roddy, one of the Attorney General's witnesses, acknowledged that above-average earnings derived entirely from productivity gains are not considered monopoly profits, even if the firm is, in fact, a monopoly (Tr. 23, at 46-49).

above-average productivity growth would have above-average earnings. Therefore, under a price cap, those above-average earnings derived from higher productivity growth would not be considered monopoly rent.

Accordingly, for all of the above reasons, we find that G.L. c. 159 does not bar the Department from adopting a price cap plan for NYNEX that does not contain a cap on earnings or allow for sharing of earnings.

In view of our determination that the Department has the authority under G.L. c. 159 to adopt price cap regulation for NYNEX without earnings sharing or an earnings cap, we must now determine whether inclusion of earnings sharing or an earnings cap is appropriate for policy reasons. Based on the record, and for the reasons described below, the Department finds that earnings sharing or an earnings cap is inappropriate in a well-designed price cap for NYNEX. [116]

Earnings sharing is intended to act as a backstop for the productivity factor, but it introduces many of the ROR regulation disincentives that price cap regulation is designed to eliminate (see Section V.A.2.b.i, for a discussion of the disincentives of

[116] While we find, based on the record in this proceeding, that it would not be appropriate to include earnings sharing or an earnings cap in the price cap for NYNEX, such a finding should not be construed as an absolute rejection of these concepts. On the contrary, earnings sharing and/or earnings ceilings may be integral components of incentive regulation plans that we approve for other utilities.

ROR regulation). One of the primary incentive benefits of price caps is the motivation for a firm to become more efficient than the average firm in order to increase its earnings. Earnings sharing would, at a minimum, reduce the marginal return of these additional earnings to a firm, and this reduction in the marginal return will have a negative effect on a firm's incentives. If the primary reason for moving from ROR regulation to price cap regulation is to lower aggregate rates by creating a profit motive for a firm to be more efficient, then earnings sharing is counterproductive because it undermines the profit incentive that would cause gains in efficiency. Under the well-designed price cap plan that we approve for NYNEX in this Order, NYNEX will have the opportunity to earn a higher return than it would have under ROR regulation, but only by becoming more efficient, not by increasing prices. Also, given that we have established a productivity offset in the price cap formula that is greater than the productivity that the average firm has achieved on an annual basis in the past 65 years (see Exh. NYNEX-3), NYNEX's aggregate rates will be lower over the term of the plan than they would be under ROR regulation, regardless of whether the Company is able to increase its profits by becoming more efficient. Therefore, we see no reason to undermine the profit motive in this price cap by including earnings sharing or an earnings cap.

In addition, one of the primary benefits of price cap regulation is that it renders unnecessary certain regulatory reviews, such as cost allocation and prudence inquiries, that have been fundamental to ROR regulation. Earnings sharing, on the other hand, requires an annual earnings report that will maintain these types of review. For example, the record indicates that NYNEX is intending to raise a significant amount of capital to invest in a broadband network (see Exh. NYNEX-8). Under a pure price cap, with no earnings sharing, NYNEX will bear virtually all of the risks of its broadband investment. If, however, the Department were to adopt earnings sharing, the prudence of NYNEX's broadband investment would be a central issue in determining whether the Company has reached the point where it should share excess earnings, and the Department would therefore be required, in the annual review of the Company's earnings, to make findings regarding the prudence of the Company's investments. We believe that it is more appropriate to allow the market to determine whether NYNEX should be rewarded or penalized for its investments, rather than attempt to make such a determination in a regulatory forum.

Also, as noted above, earnings sharing would require an annual review of earnings, which would be a significant administrative undertaking. This additional administrative burden would not be a concern for the Department if there was a corresponding benefit. However, as noted above, the benefits of earnings sharing are limited and do not outweigh the costs of (1) reducing the Company's efficiency incentives, and (2) creating an additional administrative burden for the Department, NYNEX, and interested parties.

C. Pricing Rules

1. Classification of Services

In its Plan, the Company did not propose to establish baskets for services (Exh. NYNEX-1). The Attorney General, however, proposed three service baskets (basic non-competitive, discretionary non-competitive, and competitive), with different pricing rules for each basket (Exh. AG-796, at 9).

a. Positions of the Parties

i. NYNEX

The Company argues that it is not necessary to include service baskets in a price regulation plan, as long as the plan includes a rate element index (NYNEX Brief, App. B at 23). The Company maintains that its proposed REI creates a rate basket for each individual rate element (id.). The Company argues that the Attorney General's scheme, while proposing three baskets, virtually places all services in the most restrictive basket, and thus in practice does not operate as a rate basket plan (id. at 63). The Company asserts that the classifications of service proposed by the Attorney General have no economic basis (id.).

The Company's witness, Mr. Caldwell, recommended that if the

Department is persuaded to create baskets for groups of rate elements, he would recommend that the Department use the already established customer classes as the baskets (Exh. NYNEX-39, at 5).[117] Mr. Caldwell argued that if the customer classes were used as baskets, the Price Regulation Index should apply to each class, and the REI should apply to each rate element within the class (id. at 6). Mr. Caldwell further noted that these recommendations are far superior to the intervenors' basket recommendations, but inferior to the Company's Plan (id.).

ii. Attorney General

The Attorney General argues that service or rate baskets, if properly designed, should be part of an alternative rate plan (Attorney General Brief, Part I, at 23). The Attorney General's proposed Plan would require NYNEX to classify services among three baskets based on the level of competition for each (id. at 39, citing Exh. AG-795, at 111-116). The Attorney General's proposed three baskets are (1) basic non-competitive; (2) discretionary non-competitive, and (3) competitive (id.).

The Attorney General recommends that the Department adopt a market basket approach that will provide a categorization and separation of services into competitive and non-competitive (id. at 36). The Attorney General argues that if a basket includes

[117] Mr. Caldwell noted that the existing customer classes are: Residence, Business, Coin, Carrier, and Sufficiently Competitive (Exh. NYNEX-39, at 6).

both competitive and non-competitive services, cross-subsidies are likely to result (id. at 23). The Attorney General rejects NYNEX's suggestion that if the Department adopts baskets, the baskets be based on existing rate classes, because, according to the Attorney General, "the[se] customer classes do not reflect the level of market power that the Company has nor do they reflect the extent to which the services are essential or discretionary" (id. at 37, citing Exh. AG-817, at 22).

Regarding the Company's criticism of the Attorney General's basket proposal on the ground that it places virtually all services in the most restrictive basket, the Attorney General argues that most of the Company's services are monopoly services, and, therefore, belong in the basic monopoly basket (Attorney General Reply Brief at 18, citing Tr. 28, at 32).

iii. AT&T

AT&T argues that a price cap form of regulation for NYNEX should include service or rate baskets, and that baskets should be designed based on the degree to which services are or are not subject to effective competition, in order to constrain monopoly leveraging (AT&T Brief, App. B at 8).

AT&T argues that virtually all of the Company's services in Massachusetts must be classified as monopoly (id. at 54). AT&T states that separate pricing baskets must be used for carrier access services (id.). AT&T also asserts that residential optional toll calling services should be included in a basket with toll services (id. at 56).

iv. MCI

MCI argues that service or rate baskets should be established to give the Company the appropriate level of pricing flexibility for services within the basket (MCI Brief at 38). MCI maintains that "the [Attorney General's] proposal for a competitive services basket is a good example of such a basket" (id.). MCI argues that the construction of other baskets should be determined by the policy goals of the Department; for example, according to MCI, if the goal is to restrain price shifts without using rate element indexes, the baskets could consist of services that are complements in retail consumption (id.).

MCI argues that NYNEX's basket structure "gives it significant and unjustified pricing flexibility" (id. at 28). MCI argues that the Company's approach would place all services under a single basket, with the result that an increase in the rate of one service would be offset with a corresponding decrease in the rate of another service "so long as the overall aggregate rate did not increase more than the price cap formula allowed" (id.). MCI asserts that although the Company may claim in the aggregate that ratepayers will not see rates increase, ratepayers do not purchase in the aggregate but in "discrete subsets of service from NET" (id.). Thus, different groups of ratepayers are affected differently under the aggregate approach (id.).

MCI also argues that the single basket approach provides the Company with unwarranted flexibility given that "there is simply no justification for pricing flexibility for monopoly services since, by definition, [NYNEX] faces no significant market pressure for those services" (id. at 28-29). MCI asserts that a price cap plan that allows monopoly rates to rise supports the decrease in rates for competitive services and thus allows an exercise of monopoly power (id. at 29).

b. Analysis and Findings

i. Service Baskets

The Department has established a mechanism to allow dominant carriers to price sufficiently competitive services based on market considerations. See D.P.U. 1731, at 39-40. The Department determined that market-based pricing would result in just and reasonable rates where effective competition is present. The Company proposes in this case to subject competitive services to the same REI as other services, and to include rates for competitive services in the computation of the API for the purpose of complying with the overall price cap formula. The Attorney General proposed establishment of three baskets, with a strict rate element cap on services in the basic monopoly basket.

For the reasons described below, the Department finds that the only necessary separation of services for purposes of the price cap is segregation of monopoly services from sufficiently competitive services. Accordingly, we find that it is appropriate to establish two baskets: (1) Monopoly, and (2) Competitive.

As noted, supra, rate regulation is not necessary for competitive markets; therefore, there is no reason that NYNEX's competitive services should either be subject to a rate element cap, or included in the calculation of the API for compliance with the overall price cap formula.[118] Accordingly, we find that (1) services in the Competitive Basket should be subject to no rate element indices, and (2) services in the Competitive Basket should not be included in the calculation of the API. In response to NYNEX's argument that baskets are not necessary for purposes of its price cap plan because its proposed REI essentially creates a basket for each rate element, we note that this argument does not explain the reason it is necessary to apply a rate element cap to competitive services, since such a cap would place a greater restriction on NYNEX's pricing flexibility for competitive services than currently exists (see Tr. 27, at 115-116).

[118] The Department notes that the only NYNEX services currently considered sufficiently competitive are Facilities-based Pricing Option Centrex, Intellidial, and Customer Specific Pricing tariffs. See NET-Centrex , D.P.U. 85-275/276/277 (1985); NET-Intellidial , D.P.U. 88-18-A (1988); and Customer Specific Pricing , D.P.U. 90-24 (1991).

ii. Price Floor

Although the Company did not include any price floor in its proposal (see Tr. 4, at 42-43), we find that it is necessary to include an explicit price floor for NYNEX's services, monopoly and competitive, in the price cap plan in order to prevent cross-subsidization and anticompetitive pricing. The inclusion of such a price floor will obviate the need for elaborate rate element indices and other pricing rules also intended to prevent cross-subsidization and anticompetitive pricing.

The appropriate price floor for a NYNEX rate element depends on whether the service is one in which NYNEX controls an essential input for a competitor's offering of a competing service. For those services where NYNEX controls an essential input for a competitor's offering of a competing service, in order to prevent anti-competitive pricing, the proper price floor for NYNEX's own rate element shall consist of the relevant wholesale rate that at least one competitor pays to NYNEX in order to offer the service, and NYNEX's marginal cost of related overhead. For all other services, in order to prevent cross-subsidization, the proper price floor shall be the marginal cost, as reported in the Company's most recent marginal cost study ("MCS"), MCS VI. This two-part price floor will prevent cross-subsidization and anticompetitive pricing.[119] We direct the Company to include in its initial price cap filing a listing and calculation of the relevant price floor for each service, i.e., NYNEX's marginal cost, or the relevant wholesale rate plus NYNEX's marginal cost of related overhead. Other parties will then have the opportunity to comment on whether NYNEX has proposed the proper price floor for each service.

We recognize that there are certain services, such as residence premium toll services, for which the current rate most likely violates this price floor. We direct the Company to identify in its initial price cap filing such services and to indicate how the Company intends to bring the rates for these services into compliance with the price floor.[120] Rates for all of the Company's regulated services must exceed the price floor by the Company's second annual price cap filing,[121] and rate changes made necessary solely to comply with the price floor

[119] For example, the proper price floor for NYNEX's switched access rates is the marginal cost of switched access, while the proper price floor for NYNEX's own toll rates is the relevant switched access rate plus related marginal costs.

[120] For example, the Company could make its residence premium toll services available on a wholesale basis in order to bring its retail rates for these services into compliance with the price floor.

[121] The only services that will be exempted from this rule are those that are provided an explicit, Department-endorsed subsidy, such as Lifeline and Link-Up America. The Company shall identify any such services in its first annual filing under the price cap.

shall not be constrained by any rate element indices.[122]

In summary, the Department approves the Company's proposed first pricing rule (see Section III.C.1, for a description), except that this rule will govern the allowable change in the weighted average price of all regulated services in the Monopoly basket, whether or not those services are tariffed (see RR-DPU-4). In addition, the price floor described above shall be applied to all of NYNEX's services, subject to the directives described above.

2. Rate Element Cap

NYNEX's proposed REI is defined as the percentage change in the Consumer Price Index ("CPI"), [123] plus or minus exogenous cost changes (Exh. NYNEX-1, at 6). Under the Attorney General's Plan, there are different rate element caps for each basket: Basket 1 (basic non-competitive) -- rate changes for each rate element are limited to the MAPI (i.e., lesser of PCI or CSPI); Basket 2 (discretionary non-competitive) -- rates must exceed incremental cost, and changes may not cause the weighted average change for Baskets 1 and 2 to exceed the MAPI; and Basket 3 (competitive) --

[122] Any current rate that exceeds the price floor may not be lowered below the price floor prior to the second annual price cap filing.

[123] The Company states that it proposes to use the CPI in the REI, rather than the less volatile GDP-PI, because the CPI is understandable to customers and is used by the Company today as a standard annual adjustment in other tariffs (NYNEX Brief at 62 n.22).

rates must exceed incremental cost (Attorney General Brief, Part I, at 39-40).

a. Positions of the Parties

i. NYNEX

The Company proposes a Rate Element Index ("REI"), applicable to all rates in the Company's tariff, to limit the Company's ability to increase the rates for individual rate elements by establishing a ceiling on possible increases (NYNEX Brief at 28, citing Exh. NYNEX-1, at 4). In addition, the Company notes that its Plan does not require that the Company reduce a rate element if the REI should decrease below the existing price, but that in such instances the Company could not increase the rate (id. at 58, citing Exh. NYNEX-39, at 5).

The Company argues that an REI should be a component of a price cap plan to restrict any increase in individual rate elements, while still providing pricing flexibility (NYNEX Brief, App. B at 23). The Company argues that its proposed REI "provides the appropriate balance between limits on price increases and opportunities for some price flexibility" (id.). The Company asserts that pricing flexibility under the REI is further limited by the Company's proposed freeze on rate elements for basic residential rates (id.).

The Company maintains that the Plan does not allow the Company to increase rates beyond the REI ceiling unless it receives Department approval and only under four exceptions: (1) competitive necessity; (2) legal concerns; (3) service re-structuring that might include an increase greater than the REI for one rate element and might be offset by a corresponding decrease in another element; and (4) service obsolescence where in-service quantities are minimal and require price increases rather than the elimination of service (id. at 57-58).

The Company notes that the intervenors argue (1) that the Company's proposal provides too much flexibility in adjusting prices and enables cross-subsidization of competitive services; and (2) that the Attorney General's proposed limitations on the Company's pricing flexibility are superior to NYNEX's (id. at 59). The Company asserts, however, that the Attorney General's pricing rules start from "the premise that virtually no upward adjustments in prices are warranted and that any flexibility would allow the Company to engage in anticompetitive pricing stratagem" (id. at 60). The Company also argues the Attorney General's Plan contains pricing rules that would rigidly constrain the Company's actions and are unreasonable (id.).

The Company argues that its REI "creates a basket for each rate element that strictly prescribes the extent of potential annual increases for all rates" (id. at 62). According to NYNEX, the REI ensures that prices for each rate element will not increase in real terms (id.). The Company argues that this ceiling does not exist under the current regulatory framework and "substantially limits the magnitude of possible revenue shifts among services" (id.). The Company asserts that any concern regarding underpricing of services can be brought before the Department (id. at 62-63). Also, the limited exceptions to the REI ceiling must be approved by the Department (id. at 63). The Company concludes that "the ARP has built-in mechanisms that effectively address concerns about NYNEX obtaining an unfair competitive advantage by improper pricing actions" (id.).

Regarding the Attorney General's proposal that price increases for Baskets 1 and 2 services be subject to both the PRI and a CSPI, the Company argues that "application of the general price index to individual rate elements will prevent the Company from achieving the average price level allowed by the PRI" (id. at 64, citing Exh. NYNEX-39, at 2). In addition, the Company argues that the Attorney General's pricing rules effectively require reductions in residence exchange rates and thus are in conflict with the principles of D.P.U. 89-300 and the transitional filings (id.).

The Company also criticizes the Attorney General's requirement to reduce the price for individual rate elements when the REI decreases (id. at 64-65). The Company argues that this rule could cause rates to drop below cost and rise and fall as the REI fluctuates (id. at 65, citing Exh. NYNEX-39, at 4).

Regarding the Attorney General's argument that the Plan permits the Company to delay or "bank" rate increases, thereby increasing the potential for cross subsidization, the Company maintains that many of its rate elements represent small dollar amounts and that "banking enables the Company to defer otherwise permissible changes until the percent increase can be reflected in a sensible dollar amount" (id. at 65, citing Exh. NYNEX-39, at 7).

Regarding the Attorney General's and other intervenors' opposition to the Company's ability to deaverage rates over the term of the Plan, the Company argues that the Plan "permits a competitor to raise a challenge if a deaveraging proposal is viewed as being anticompetitive" (id. at 66). NYNEX also notes that it may propose to deaverage rates under the current regulatory framework (NYNEX Reply Brief at 25).

ii. Attorney General

The Attorney General argues that his proposed MAPI is an appropriate rate element cap, and that a rate element cap should be used along with well-designed market baskets (Attorney General Brief, Part I, at 23). [124] The Attorney General argues that his pricing rules differentiate between competitive and

[124] The Attorney General maintains that his proposed pricing rules are closer to what has recently been adopted in Vermont and Illinois than the Company's proposed pricing rules (Attorney General Brief, Part I, at 41).

non-competitive services and restrict the Company's ability to raise non-competitive rates (id. at 41).

The Attorney General notes that under the Plan, NYNEX may raise "any individual rate any year over the next ten years by a percentage equal to the then cumulative change in the CPI" (emphasis in the original) (id. at 37). The Attorney General holds that this banking of increases for future years allows NYNEX to expand the amount of price increases over time and enlarges the potential for cross subsidizations (id.). The Attorney General refutes NYNEX's assertion that a plan to bank increases under the REI merely allows the Company to change prices in a reasonable manner (Attorney General Reply Brief at 18). The Attorney General argues that it is not reasonable to allow a "dominant carrier in a declining cost industry to raise non-competitive rates by the cumulative rate of inflation over a ten year period," as the Company proposes (id.). The Attorney General asserts that banking is counter to the development of competition (id.). The Attorney General also criticizes NYNEX's REI cap because of the Company's proposed exceptions to the cap (Attorney General Brief, Part I, at 37-38).

The Attorney General refutes the Company's criticism that lowering rates as the REI decreases could cause "see-saw rates" (Attorney General Reply Brief at 18). The Attorney General argues that lowering rates is acceptable "if the rate movement is tracking the Company's costs and productivity," and that a see-saw effect is unlikely if the initial rates are set properly (id.).

The Attorney General claims that the pricing freedom provided under the Company's Plan would hinder competition because NYNEX would lower rates for competitive services and increase rates for monopoly services (Attorney General Brief, Part I, at 34). The Attorney General argues that the Plan would be more anticompetitive than classic predatory pricing[125] because the Company would be able to "undercut its competitors without ever giving up any revenues at all, since while it is suppressing competitive prices, NYNEX could make up every bit of the revenues from non-competitive services" (emphasis in the original) (id. at 34, citing Exh. AG-795, at 29). The Attorney General argues that, under the Company's REI, NYNEX would be able to determine the level of rate increase depending on the level of competition and the service's price elasticity (id. at 35). Thus, the Attorney General contends that if the Department wants to foster competition, the Plan must include a "tighter constraint on cross-subsidization and anticompetitive pricing than the generic

[125] According to the Attorney General, predatory pricing occurs when a dominant provider forgoes revenues for a period of time in order to undercut competition and is able to raise prices once competition is frustrated (Attorney General Brief, Part I, at 34).

REI cap in the NYNEX Plan" (id. at 36).

iii. AT&T

AT&T argues that a rate element index is necessary to constrain price changes in service baskets (AT&T Brief, App. B at 8). AT&T further argues that the degree of pricing flexibility granted to the Company for monopoly services must be substantially constrained, with prohibitions against cross-subsidization and predatory pricing (id. at 54).

Regarding the Company's proposed REI, AT&T claims that as "there is no productivity offset for individual rate elements, all productivity improvements in monopoly services may potentially produce monopoly profits" (AT&T Reply Brief at 12). AT&T argues that a productivity offset should be applied in the rate element index for monopoly services (id. at 13).

AT&T maintains that "where substantial pricing flexibility is permitted, economists predict[ ] that the monopolist will use price discrimination as a monopoly leveraging device," and that the pricing flexibility allowed under NYNEX's Plan would allow the Company to engage in the type of predatory pricing predicted by economic principles (AT&T Brief at 36, citing Exh. AT&T-145, at 14). AT&T asserts that the proposed REI would allow the Company to increase the rates for monopoly services, and, because there is no price floor established under the Plan, the Company would be able to reduce those rate elements that apply to services in markets where NYNEX now faces or potentially may face competition (id. at 36-37). AT&T maintains that there are no pricing rules in the Plan that limit the Company's ability to choose which rate elements it decides to increase to the maximum allowed, to hold steady, or to decrease (id. at 38).

iv. MCI

MCI argues that there is no justification for pricing flexibility for monopoly services, and, where a price cap plan permits monopoly rates to rise, "that is a de facto abuse of monopoly power" (MCI Brief at 29). MCI further argues that the Attorney General's proposal appropriately recognizes that there is no justification for pricing flexibility for monopoly services in that the Attorney General's proposal would apply the price cap formula on a rate element basis (id.). Therefore, according to MCI, NYNEX would not have the ability under the Attorney General's Plan to fund decreases in competitive service rates with corresponding increases in monopoly service rates (id.).

v. NECTA

NECTA argues that rate element pricing flexibility proposed by the Company "will allow the Company to engage in anticompetitive mischief in order to cross-subsidize its competitive activity and forestall the development of competition" (NECTA Brief at 25). In addition, NECTA asserts that, contrary to NYNEX's statements, the Plan would allow NYNEX to "recoup lost revenues through increases in prices for (1) monopoly services, (2) any other service for which market alternatives do not presently exist, and (3) all services in geographic areas of the Commonwealth in which competition has not occurred" (NECTA Reply Brief at 16).

vi. FEA

FEA argues that the Company's Plan "provides far too much flexibility for the Company to change its prices" (FEA Brief at 9). FEA criticizes the Company's proposed REI because "the Company could petition the Department to violate the rule concerning individual rate elements in a number of circumstances" (id.).

b. Analysis and Findings

As noted in Section V.A.2.b.i, supra, the extent to which allocative efficiency is achieved under price cap regulation is a function of the pricing rules for individual rate elements. The Company has proposed a rate element cap that would ensure that each individual rate element could not increase above the inflation rate for the duration of the Plan.[126] The Attorney General and other parties have recommended much stricter pricing rules to (1) limit the Company's ability to cross-subsidize and to price anticompetitively, and (2) require that the Company

[126] This assumes that exogenous cost changes are not sufficient to cause the allowed rate change to exceed the Consumer Price Index.

allocate productivity gains to all services rather than to rates in the aggregate.

Regarding the issue of cross-subsidies and anticompetitive pricing, as described above in Section VI.C.1.b.ii, the Department has approved a price floor to address these concerns more effectively than can be accomplished through rate element pricing rules. Thus, the only remaining issue regarding the Company's proposed rate element index is whether productivity gains should be allocated equally to all services.

Allocating productivity gains equally to all services would prevent the achievement of full efficiency in telephone pricing. Because the rate element index controls the level of pricing flexibility, the Department must determine whether to allow NYNEX sufficient flexibility to continue the type of rebalancing that has occurred in the transitional rate-rebalancing process. As noted, supra, in Section V.A, the Department is not abandoning its commitment to competitive markets, and maximization of allocative efficiency is inherent in competitive markets. Therefore, the Department finds that the Company's proposed REI should be adopted for the Monopoly Basket, in order to give the Company sufficient pricing flexibility to promote continued movement toward the type of economically efficient rates that will be more compatible with emerging competitive markets than today's regulatorily determined prices.

Several parties raised additional arguments in opposition to the Company's proposed REI, and we will respond to those arguments here. In response to the Attorney General's argument that it would be unreasonable to allow the Company to bank allowed price increases over time, we note that the even a banked price increase under the REI would still be less than the rate of inflation over the relevant period of time. Also, we agree that banking is necessary to allow price increases using the most sensible dollar amounts. In response to the Attorney General's argument that the Company's REI is unreasonable because it does not require a rate element decrease if the REI is a negative number, we note that the REI actually serves as a ceiling for allowed changes, and not as an index for determining the specific degree of changes in individual rates.

In addition, NYNEX's pursuit of economic efficiency may eventually lead to pressure for some form of geographic rate deaveraging. If the Company proposes in the future to deaverage rates, the Company will be required to show that the each deaveraged rate is equal to or greater than the actual deaveraged marginal cost for that service, in order to comply with the price floor described in Section VI.C.1.b.ii.

Given pricing flexibility, the Company in its own self-interest should move toward economically efficient rates. However, the Company's proposed REI, in addition to the proposed freeze in basic residence rates, would make that transition gradual, thus guaranteeing that no monopoly rate element would be subject to an inflation-adjusted price increase over the duration of the plan. By allowing a transition to economically efficient rates to occur in a gradual manner with rate changes lower than inflation, the Company's REI promotes the Department's goals of economic efficiency, rate continuity, simplicity, and universal service.

Accordingly, the Department approves the Company's proposed second pricing rule, but only for tariffed services in the Monopoly basket, and subject to the findings below regarding (1) the Company's proposed additional adjustments for flat rate services (see Section VI.C.4.b), and (2) the Company's proposed freeze on basic residence service rate elements (see Section VI.C.5.b).[127]

The Department also approves the Company's proposed third pricing rule, which would allow price increases only at the time of the annual filings.[128] Several parties have suggested that if the price cap formula allows, and the Company takes advantage of,

[127] Contrary to suggestions of FEA, we find that the Company's proposed exceptions to the REI are reasonable.

[128] Under the Company's Plan, the first annual filing would be made by the Company on June 1, 1995. Because that date is less than one month from the date of this Order, the Department will allow the Company to make the first annual filing on July 1, 1995, for effect September 15, 1995.

an overall increase in rates, the annual filings would represent "a general increase in rates," as described in G.L. c. 159, § 20, and that the Department thus would be required by statute to (1) notify the Attorney General, (2) provide notice to the public, (3) hold a public hearing, and (4) make an investigation as to the propriety of such proposed rate changes. Because the allowed price changes resulting from application of the price cap formula could cause the Company's aggregate revenues to increase, we agree that the annual filings would most likely constitute a general increase in rates under G.L. c. 159, § 20.[129] Therefore, the Department will, at the time of an annual filing, notify the Attorney General of such filing, provide notice to the public, hold a public hearing, and investigate to determine whether the Company has complied with the rules of the price cap plan.[130] However, consistent with our findings in Section V.A.2.b.iii, supra, regarding the risk of recontracting, the Department will not allow parties in the investigations of the annual filings to

[129] As long as the Company complies with the pricing rules, we anticipate that the investigation of the annual filings will be routine and should be completed in the time between the issued and effective dates of the Company's proposed tariff revisions (i.e., between June 1 and August 15). Even for a general increase in rates, the statute permits, but does not compel, a tariff suspension for purposes of a Department investigation. See G.L. c. 159, §§ 19, 20.

[130] Because the price cap plan is designed so that any rate changes will result in just and reasonable rates, compliance with the pricing rules will be considered evidence of the propriety of the proposed rate changes.

petition for changes to the price cap plan, unless such a petition is made (1) to reflect the impact of federal or state legislation or court decisions enacted or issued subsequent to the Department's approval of the plan, or (2) to seek a less structured form of regulation or deregulation of NYNEX's operations based upon changes in market conditions.

3. Competitive Services Price Index

A competitive services price index ("CSPI") was included in the Attorney General's Plan as one of two measurements to be used as the MAPI (the other being the Price Cap Index), depending on which is less in any given year (Exh. AG-796, at 2-4). The Attorney General defined the CSPI as a calculation of the annual and cumulative change in the price of all services included within the Competitive Basket, exclusive of Yellow Pages revenue (id.).

a. Positions of the Parties

i. NYNEX

NYNEX argues that a price cap form of regulation should not include a CSPI as a component (NYNEX Brief, App. B at 22). The Company asserts that the use of a CSPI (1) defeats the purpose of the price cap formula, which is to ensure that prices track costs without diminishing the incentive to reduce costs, and (2) renders all of the economic analysis of the productivity target irrelevant (id.). NYNEX argues that there is no valid economic justification for requiring that price reductions for competitive services match price reductions for non-competitive services (id.).

ii. Attorney General

The Attorney General's witness, Dr. Selwyn, proposed the adoption of a CSPI as a mechanism to help ensure that monopoly service customers share in the benefits of competitive pricing (Attorney General Brief, Part I, at 43). Dr. Selwyn also maintained that the CSPI, along with other restraints, could eventually obviate the need for cost allocation reviews, though he recommends for the interim that the CSPI supplement cost allocation (id. at 44).

The Attorney General notes that the Company has made three arguments in opposition to the CSPI: (1) competitive prices may be reduced because their prices are above incremental cost; (2) the CSPI would prevent prices from tracking costs because monopoly price changes are unrelated to competitive price changes; and (3) no state has yet adopted a CSPI (id. at 43-44). Responding to these three arguments, respectively, the Attorney General asserts: (1) this concern would be moot if the Department sets just and reasonable starting rates for each rate class; (2) services are not unrelated and share a vast amount of common plant; and (3) the CSPI has not been explicitly accepted or rejected anywhere, but "there is a first time for all good ideas" (id.).

iii. AT&T

AT&T argues that a price cap form of regulation should not include a CSPI because, according to AT&T, the pricing of monopoly and competitive services should not be required to move in "lock-step" (AT&T Brief, App. B at 7).

iv. MCI

MCI maintains that a CSPI is appropriate for inclusion in a price cap form of regulation, and that it should be calculated as described by the Attorney General (MCI Brief at 38).

b. Analysis and Findings

Consistent with the Department's other findings regarding pricing flexibility and the requirement that the Company price all of its services above a price floor to prevent cross-subsidization and anticompetitive pricing, the Department finds that it is not necessary to include a CSPI in the price cap plan. Such an index would be redundant since the adoption of a price floor accomplishes the same goal that the CSPI is intended to accomplish. Also, the CSPI would severely limit the Company's ability to continue the transition toward more market-responsive rates. Moreover, the CSPI is really just one other method to ensure that productivity gains are allocated equally to all customers and rate elements, and, as we have found in Section VI.C.2.b, allocation of productivity gains equally to all customers and rate elements is unreasonable because it would tend to limit the achievement of overall efficiency.

4. Usage Adjustment for Flat Rate Services

As an additional component of the Company's proposed rate element index ("REI") for certain services with a flat-rate usage component, the Company proposed to add or subtract the percent change in average usage (Exh. NYNEX-1, at 8). The Company states that for the purpose of determining the percent change in average usage associated with specified flat-rate services, it shall use the average minutes of usage per line for the two calendar years immediately preceding the annual filing (id.).

a. Positions of the Parties

i. NYNEX

The Company argues that its proposed usage adjustment to the rate element cap for unlimited premium toll services is reasonable (NYNEX Brief, App. B at 24). The Company maintains that it is appropriate to include the percent change in average usage per line in order to take into account the change in costs associated with the change in usage for unlimited services (id.).

The Company also contends the Attorney General's assertion that the usage adjustment on unlimited calling plans is contrary to economic efficiency is unfounded (NYNEX Brief at 65). The Company argues that its proposal is intended to ensure that usage purchased under an unlimited plan and usage purchased on a measured basis are similarly priced (id.). The Company asserts that this is consistent with the direction taken for optional toll calling in the transition process, and that an adjustment in the REI for premium toll services is consistent with Department objectives of giving customers appropriate pricing signals and having customers pay comparable prices for similar services (id. at 66). The Company asserts that the usage adjustment prevents rates for unlimited usage and measured usage from becoming "significantly skewed" over the term of the Plan (id.).

ii. Attorney General

The Attorney General argues that average usage adjustments for premium toll services should not be allowed, because such adjustments would be contrary to economic efficiency and could possibly deter "economic development associated with increased use of telecommunications-based services, such as Internet, telecommuting, etc." (Attorney General Brief, Part I, at 23-24, citing Exhs. AG-795, at 32-34; AG-817, at 24).

b. Analysis and Findings

Depending on the particular service, unlimited business exchange and certain residence premium exchange services (e.g., Metropolitan, Suburban, Circle Calling, Bay State East, and Call Around 413 Plus services) consist of the dial-tone line rate and one or more of the following usage components: local, flat-rate premium, and toll premium. Under the transitional rate-rebalancing, the usage components have been priced based on the average monthly minutes of usage per line multiplied by the target usage rate approved in D.P.U. 89-300. D.P.U. 89-300, at 125. The Company has proposed that the percent increase in average usage per line should be applied in the adjustment to the REI for flat-rate services, except for residence local unlimited service, which is subject to the proposed rate freeze.

While the Company argues that any increase in usage represents an increase in the cost of providing service, the record indicates that any cost changes associated with increased network usage are de minimus,[131] and that the target rates used in the calculation of the current average usage rates are well above marginal cost. Therefore, we find that the pricing flexibility of the REI will be sufficient to allow NYNEX to recover its costs associated with these services. In addition, we no longer consider it appropriate to assume that the pricing signals of flat-rate and measured services should be considered strictly on the basis of average usage, because customers of flat-rate services most likely derive value directly from the knowledge that they do not have to pay a usage charge, even if it would be

[131] The marginal cost of a local intraoffice peak minute of use is $0.00258 and the cost, per-message, for billing the call is $0.000007 (see Exh. AG-439). The marginal cost of an interoffice peak minute of use is $0.0096, with a per-message cost of $0.0013 (see id.).

less expensive for them to subscribe to measured service.[132] Accordingly, NYNEX shall not include a usage factor in the calculation of the REI for services with an unlimited usage component.

5. Basic Residence Rate Freeze

Under the Company's proposed second pricing rule, certain basic residence service rate elements would be capped until the annual filing made by NYNEX in June 2001 (Exh. NYNEX-1, at 8).

a. Positions of the Parties

i. NYNEX

NYNEX argues that its proposed basic residence rate freeze, guaranteeing that basic local residential rates do not increase until the year 2001, is reasonable (NYNEX Brief, App. B at 28). NYNEX maintains that the freeze provides additional safeguards and benefits for residential customers and enhances the goal of universal service (id.). In addition, the Company argues that because the freeze caps the rates for services that comprise approximately 30 percent of the Company's revenues, the source of revenues for potential rate increases is substantially limited (id. at 61).

ii. Attorney General

The Attorney General argues that the proposed rate freeze is

[132] Such benefit is sometimes termed the "option value" of a flat-rate service.

not reasonable because the rates for services subject to the freeze should instead be decreased under the terms of the Attorney General's proposed Plan (Attorney General Brief, Part I, at 25, citing Exh. AG-795, at 44-45). The Attorney General maintains that, in the context of a decreasing cost trend in the telecommunications industry, capping basic residential rates "is not a means of protecting captive customers in Massachusetts" (id. at 25).

iii. AT&T

AT&T maintains that NYNEX's proposed basic residence rate freeze is not reasonable because the Company should be required to continue the transition to target rates (AT&T Brief, App. B at 10). AT&T argues that freezing local residential rates "would constitute an impenetrable barrier to competitive entry in the local exchange market, the `last mile' to the consumer" (id.).

iv. MCI

MCI argues that NYNEX's proposed basic residence rate freeze is not reasonable because it offers customers nothing more than what they should otherwise expect regardless of the form of regulation (MCI Brief at 39). MCI maintains that the record in this case demonstrates that residential exchange customers are paying rates "well in excess" of cost (id. at 11, citing Exhs. MCI-4; MCI-5).

v. NECTA

NECTA argues that the limited rate freeze for residential exchange service rate elements does not insulate those customers from risks associated with NYNEX's operations (NECTA Reply Brief at 13). NECTA argues that the freeze would last only six years and would apply to only one portion of a residence customer's bill (id.). In addition, NECTA argues that the Plan would allow it to deaverage rates by reducing residential rates in certain exchanges and increasing rates in other exchanges (id.).

vi. FEA

FEA argues against the proposed rate freeze because it is inconsistent with achievement of target rates under the transition process (FEA Brief at 3-4). FEA also argues that the rate freeze prevents the development of competition in Massachusetts because, to be competitive, NYNEX must reduce rates for competitive services, which are mostly business services, and such reductions would only occur if the Company can increase residential rates (id. at 7).

b. Analysis and Findings

The current residence dial-tone line monthly rate of $9.91 is below the corresponding target rate of $15.00, and the transition to the target rate was to be completed in two additional annual filings. D.P.U. 93-125, at 20. Although the proposed rate freeze could delay achievement of allocative efficiency for those few rates subject to the freeze, we find that the proposed freeze benefits Massachusetts residential customers and outweighs the cost of the delay in the achievement of fully cost-reflective pricing.

Specifically, we find that the proposed freeze on basic residential rates is reasonable because it will help to ensure that the Department's policy goal of universal service will be promoted under the Plan. Also, because the rates subject to the freeze all exceed their marginal costs (see Exh. MCI-5), the rate freeze will not have an anticompetitive effect. [133]

In response to the Attorney General's argument that, because of declining telecommunications costs, a rate freeze is not reasonable because it would not require the Company to allocate productivity gains to basic residential services, as we have found in Section VI.C.2.b, supra, equal allocation of productivity gains to all services should not be required because it would prevent the achievement of allocative efficiency in telephone pricing.

6. Quality of Service

Under the Company's proposed Plan, the fifth pricing rule requires that the effective date of any price increases allowed under the Plan be subject to the Company meeting specified levels in a proposed Service Quality Index ("SQI") (Exh. NYNEX-4, at 6).

[133] NECTA's concern regarding rate deaveraging is addressed in Section VI.C.2.b, supra.

The fifth pricing rule specifically mandates that NYNEX forego any price increases for the number of months that the SQI falls below specified levels (id.).

a. Positions of the Parties

i. NYNEX

The Company asserts that its proposed SQI would ensure the maintenance of a high quality of service under the Plan by "linking the timing of future price increases to the achievement of the established quality of service targets" (NYNEX Brief, App. B at 13). NYNEX asserts that predicating any future price increase on the twelve service quality items in its proposed SQI "creates a clear incentive to maintain service quality levels during the term of the Plan" (id. at 90).

NYNEX points out that of the twelve measurements, only two do not currently have Department-approved thresholds: (1) Percent Appointments Missed - Company Facilities (a new measurement item); and (2) Toll and Assist - Average Speed of Answer (for which no Department threshold has been established) (id. at 91). NYNEX notes that its proposed Standard and Target level ranges for the other ten SQI items were based on 1992 and 1993 actual quality of service results in Massachusetts and on future expectations (id. at 91-92, citing Exh. NYNEX-7, at 6). Thus, according to the Company, in some instances it has used the Department threshold currently included in the Company's quality of service reports as a benchmark standard; in others it has used a more stringent standard (id. at 92, citing Exh. NYNEX-7, at 3, 6-7).

NYNEX argues that its proposed Standard and Target levels are "reasonable and reflect the Department's thresholds as set forth in D.P.U. 89-300" (id. at 93). The Company argues that its proposed ranges are "suitable benchmarks for purposes of the SQI" because the Company has improved and updated its thresholds in its current quality of service reports, and has reflected these changes in its SQI (id. at 93-94). In addition, the Company asserts that its proposed link between service performance levels and future price increases reasonably assures that the Company will maintain and improve the quality of its service (id. at 94 citing Tr. 26, at 84-85).

The Company argues that the Attorney General's recommendations for the service quality index are "far more severe than the current quality of service standards applicable to the Company in Massachusetts" (id. at 93). The Company argues there is no justification for the Attorney General's recommended SQI penalty that would increase the productivity offset in the price cap formula by one-twelfth of one percent for each month the SQI falls below the standard level (id. at 92). NYNEX asserts that the "Company has improved its service quality over the last three years without the Department imposing any penalties such as those contained in the Attorney General's [P]lan" (id. at 93). The Company considers the Attorney General's proposal to increase productivity targets and implement a negative scoring system as punitive and without justification (id. at 94). NYNEX asserts that the Attorney General's recommendation for a negative scoring system comes "at a time when the Company's historical quality results are very good and the Company promises a continuation of those high standards as part of its service commitments under Plan" (id.).

The Company also argues that the additional measurements and disaggregated reporting requirements recommended by the Attorney General are not feasible because of operations and system constraints (id. at 93).

ii. Attorney General

The Attorney General recommends that the Department adopt a price cap formula that includes a service quality term, "Q," which would be either zero or a negative amount, as an economic penalty if the Company does not meet certain service quality standards (Attorney General Brief, Part I, at 73). The Attorney General proposes a one-twelfth of one percent increase in the productivity offset for every month in which the SQI is below the required level (Exh. AG-795, at 99). In addition, the Attorney General recommends changes to the measurement of the SQI (id. at 101-102).

The Attorney General recommends that the Department adopt his proposal for a quality of service plan as a substitute for the SQI in the Company's Plan (Attorney General Brief, Part I, at 20). The Attorney General asserts that a well-designed price cap plan encompasses two goals relative to service quality: (1) to improve service quality in response to technological developments through the use of proper incentives; and (2) to deter degradation of the quality of service of noncompetitive telecommunications services through economic penalties (id. at 68). The Attorney General argues that NYNEX's proposal would not accomplish these goals (id.).

The Attorney General states that to make a penalty effective in a declining cost industry, the penalty should not be limited to the timing of rate increases, as NYNEX suggests, but should be established as a "percentage adjustment to the productivity offset, so that the penalty stays in effect if rate decreases are necessary" (id. at 73-74, citing Exh. AG-795, at 105).

The Attorney General holds that "the Company's performance levels that have been selected as targets for the twelve SQI items are set too low in relation to NYNEX's historical experience" (id. at 70). The Attorney General asserts that in many instances the Standard SQI is below NYNEX's service quality levels of recent actual performance, and that "for 5 of the 12 quality of service items, even the Target level is set below

NYNEX's most recent actual performance" (id.). The Attorney General also argues that NYNEX's scoring system allows the Company to compensate poor performance on half of its service items as long as it achieves Target level performance on the other half of the performance measures (id. at 71).

The Attorney General states that another shortcoming of the Company's SQI plan is the lack of penalty for poor performance at either the particular wire center or SBU, because the SQI is comprised of an average score at the respective levels (id.). The Attorney General asserts that the geographic averaging of service quality information and the lack of penalty for deficient performance in a wire center or SBU "adversely exposes consumers to risk of service degradation" (id. at 72).

The Attorney General asserts that, under the Company's Plan, "once quality of service drops below the Standard level, the Company is subject to no further penalty, no matter how bad service quality gets" (id. at 73). The Attorney General further criticizes NYNEX's proposed delay in price increases as an effective penalty, since that penalty "is not likely to happen because ... the `going-in' levels are already understated and the minimum score of 26 is not sufficiently aggressive" (id.).

The Attorney General rejects Dr. Taylor's position that it is inappropriate and inconsistent with "the principles of alternative regulation for the company to face specific economic penalties for degrading the quality of its non-competitive services" (id. at 74, citing Exhs. AG-795, at 98; NYNEX-37, at 45). The Attorney General asserts that both the Attorney General's and NYNEX's quality of service proposals are intended to provide NYNEX with an incentive to maintain service quality, and that the major difference between the two plans "has to do with implementation rather than theory ...." (id. at 74, citing Exh. AG-817, at 18).

In addition, the Attorney General argues that the Department should continue to require "the Company to file the detailed, comprehensive and frequent reports on quality of service ordered previously" in D.P.U. 89-300, to ensure that the quality of service provided to non-competitive customers is not sacrificed to the quality of service provided to competitive customers (id. at 75-76). The Attorney General also asserts that the growing importance of network reliability warrants the Department to require NYNEX to report the causes of all major interoffice fiber, cable, and switch failures (id. at 76, citing Exh. AG-795 at 102; RR-AG-10; RR-AG-11).

iii. AT&T

AT&T asserts that NYNEX oversells the pluses of its proposal concerning the "quality of service commitments that it suggests are dependent upon the adoption of its [Plan]" (AT&T Reply Brief at 8). AT&T claims that NYNEX has an on-going legal obligation to ensure "technologically advanced, reliable telecommunications services throughout Massachusetts" (id.). AT&T asserts it is in NYNEX's own economic self-interest to keep its network up-to-date and to assure an adequate quality of service (id. at 8-9).

iv. NECTA

NECTA asserts that "NYNEX's alleged ... quality of service commitments are nothing more than lesser obligations the Company already has under existing Department regulation" (NECTA Brief at 62). NECTA asserts that price regulation should not be granted to NYNEX to reward the Company for "doing what it is already obligated to do: provide reliable service to ratepayers at the lowest reasonable cost" (id. at 63).

b. Analysis and Findings

Because price cap regulation introduces a financial incentive for the regulated firm to reduce costs, a well-designed price cap plan must include some form of protection against a reduction in service quality for monopoly customers. Otherwise, NYNEX could increase profits by reducing service quality for captive customers. This reduction in service quality would be tantamount to a price increase. Both NYNEX and the Attorney General included a service quality component in their proposed price cap plans, but they differ on the details of how such a component should operate. However, they both agree that in some form the Company must have a financial incentive under a price cap form of regulation to maintain or achieve a specified level of service quality. [134]

In its petition, the Company proposed an overall performance threshold in its proposed service quality index, or SQI, of 26 points. However, the record indicates that the Company has maintained an overall SQI score between 33 and 37 points on a monthly rolling average basis from April 1993 to April 1994 (see Exh. AG-207). Accordingly, a 26-point performance threshold would permit a reduction from current service quality performance levels without any financial penalty to the Company. We find this to be unreasonable. The Department finds that a service quality threshold of 33 points is an appropriate level for overall standard performance given that the Company has achieved this level on average over the most recent annual period measured. [135]

[134] The Department does not agree with the suggestion of some parties that price cap regulation is a "reward" for the Company maintaining a specified level of service quality. The purpose of a service quality component of a price cap is to ensure that the Company does not act on its incentive to cut costs to the detriment of service quality. The Company and the Attorney General both proposed a penalty for not achieving a specified service level, not a reward for achieving that level.

[135] The Department also agrees with the Attorney General's suggestion that, in addition to the annual and monthly quality of service reports that the Company currently files with the Department, the Company be required to report major network failures to the Department as such failures occur. However, we do not agree that additional measurements and

(continued...)

As a penalty for not achieving the threshold level of performance in the SQI, the Company proposed a delay of one month in the allowed price increases for each month in which the SQI is below the threshold. The Attorney General, however, has recommended an increase in the productivity offset by one-twelfth of one percent for each month the overall SQI falls below the standard measure (see Exh. AG-795, at 99). The Department finds that the Attorney General's penalty provision is more appropriate because the Company may not be allowed, or may not plan, any price increases in a particular year, thus making its proposed penalty potentially inoperable. [136] Failure to meet the 33-point threshold for overall performance in any given month thus will result in an increase in the productivity offset by one-twelfth of one percent for purposes of the subsequent annual filing. [137]

In addition, the Department finds that the Company should also have a financial incentive to achieve standard performance for individual service items, as well as for the overall

[135] (...continued) disaggregated reporting requirements are necessary.

[136] Contrary to the Company's assertion, we do not agree that an economic penalty for reduced service quality is inconsistent with price regulation. As noted, supra, NYNEX would have an incentive under a price cap to reduce service quality for captive customers, and a well-designed price cap plan for NYNEX is one that responds to the Company's incentives, not to its promises.

[137] Any resulting increase to the productivity offset shall not carry over to any future annual filings.

measurement of service quality. Therefore, we find that when three or more of the twelve individual service items that comprise the SQI fall below the standard threshold in a given month, the productivity offset shall be increased by one-twelfth of one percent for purposes of the subsequent annual filing.

Accordingly, we approve the Company's proposed fifth pricing rule, with modification to indicate that (1) failure to achieve 33 points in the measurement of the SQI in any month will result in an increase of one-twelfth of one percent in the productivity offset in the subsequent annual filing, and (2) when three or more of the twelve individual service items that comprise the SQI fall below the standard threshold in any month, there shall be an increase of one-twelfth of one percent in the productivity offset in the subsequent annual filing.

7. Access Pricing

In its petition, the Company stated that switched access rates would be decreased in two steps, starting with the June 1, 1995 filing, to achieve the target rates established in D.P.U. 89-300 (Exh. NYNEX-1, at 12).

In addition, in each annual filing NYNEX would demonstrate that the average differential between switched access rates and NYNEX's own toll rates is no less than $0.011 (id.). However, the Company indicated that the differential could fall below $0.011 during the year, as a result of individual tariff filings made between annual filings (id. at 12-13).

a. Positions of the Parties

i. NYNEX

NYNEX asserts that the Department, in D.P.U. 89-300, found it necessary to link toll and access prices to ensure that rates for services with similar costs be priced comparably (NYNEX Brief at 69). The Company argues that the proposed $0.011[138] rate differential between toll and access prices was litigated fully and decided by the Department in D.P.U. 89-300 (id. at 70). The Company thus claims that the Plan is consistent with the Department's earlier findings and policies regarding toll and access pricing (id.). Moreover, NYNEX contends that, under the Plan, the price differential between toll and access prices would likely be greater than $0.011, given the proposed reduction in switched access rates and the proposed basic residence rate freeze (id. at 71).

Regarding the carriers' argument that switched access prices be set equal to marginal cost, NYNEX claims that the Department's policies are clear as to the timing of toll and access reductions and that the retail/wholesale relationship would be limited by the extent of access price reductions (id. at 71-72). Moreover,

[138] According to NYNEX, the proposed average differential of $0.011 per minute between access and toll services consists of $0.008 per minute of retail overhead costs and $0.003 associated with the retail per message charge (NYNEX Brief at 67-68).

NYNEX argues that, under current Department policy, switched access rates could not be set to recover revenues below the carrier access class' fully allocated costs because all customer classes are required to recover their fully allocated costs (id. at 72).

Regarding the possible reduction in the price differential between annual filings, NYNEX argues that because the retail costs included in the differential do not vary with demand, the Company should not be required to recover the costs from each rate element or service but should have the flexibility to recover them on average from all retail toll services (id. at 72-73). NYNEX claims that the argument that the proposed application of the price differential could lead to a price squeeze is without merit because the Company is not proposing to price toll rates below the applicable access charges and relevant costs (id. at 73). In addition, the Company claims that the Plan provides a mechanism for the Department to investigate allegations of anticompetitive pricing in particular cases (id.).

While agreeing with the interexchange carriers ("IXCs") that access charges are currently set above cost, the Company disagrees with the recommendation that access charges be exempted from increases once they reach their target levels (id. at 74). The Company claims that other services, including toll services, also are above cost because they have to provide contribution to cover common costs and the Company's revenue requirement (id.).

Regarding the residence premium toll calling plans, NYNEX argues that the Plan includes a mechanism for addressing competitors' concerns about the prices for these services (NYNEX Reply Brief at 28). The Company asserts that competitors can request that the premium services be unbundled or offered for resale (id., citing Exh. NYNEX-5).

ii. Attorney General

The Attorney General argues that the Department should make sure that NYNEX does not price switched access services in an anticompetitive manner (Attorney General Brief, Part I, at 24).

iii. AT&T

AT&T maintains that access charges should first be reduced to their target levels and then further reduced to their economic cost; otherwise, according to AT&T, NYNEX could use monopoly profits earned from access charges to inhibit effective competition (AT&T Brief at 41). AT&T notes that in arguing for a reduction in access rates to their economic costs, it is requesting that the Department reconsider its decision in D.P.U. 89-300 with regard to the current structure and level of access charges. AT&T claims that it has presented evidence in support of its argument and that no Department decision is "written in stone, and it is always open to parties to present evidence and analysis to the Department," in support of a request for a change (AT&T Reply Brief at 15-16).

Moreover, AT&T claims that NYNEX's proposed $0.011 average differential between toll and access charges is faulty because it: (1) is an average differential allowing NYNEX to price anticompetitively; (2) need not be maintained between annual filings; and (3) imposes a price squeeze on NYNEX's competitors (AT&T Brief at 42). AT&T argues that the price squeeze is a direct result of the wholesale access rate being held above its incremental cost, and it only can be corrected by eliminating the $0.011 differential and by pricing access at its incremental cost (id. at 43). AT&T contends that the $0.011 differential is based on a calculation of marginal cost that does not include retail overhead costs, such as advertising and marketing, associated with the provision of services (id. at 43-44). AT&T claims that such costs are real costs that NYNEX and other carriers incur and that the proper way to include such costs in the price of a service is to calculate the average incremental cost of the entire service [139] (id. at 44).

AT&T contends that NYNEX's argument that the retail costs are not marginal costs that vary with demand is wrong because

[139] AT&T argues that the average incremental cost of the entire service is calculated by dividing total service long-run incremental cost ("TSLRIC"), which includes the service overhead cost items, by the quantity. According to AT&T, the average incremental cost will always be higher than the marginal cost as defined by NYNEX (AT&T Brief at 44).

such retail overheads are "fully available if toll service is discontinued and therefore represent the recovery of TSLRIC that do vary with changes in demand" (AT&T Reply Brief at 17). AT&T, therefore, requests that the Department require that NYNEX's retail toll prices include both access costs [140] and the long-run incremental costs of the overhead services (AT&T Brief at 44-45).

Furthermore, AT&T claims that the current structure of the optional calling plans [141] provided by NYNEX is the most anticompetitive form of price squeeze because four of these services are priced below the average access charge that the competitors would have to pay NYNEX (id. at 46). Thus, AT&T argues that in order to compete with the Company for subscribers to optional calling plans, NYNEX's competitors would have to set their toll rates below the access charge that they would have to pay NYNEX (id.). AT&T contends that this problem would get worse if the Department allows NYNEX to offer more optional plans, as proposed under the Plan (id.). AT&T claims that the introduction of new bundled services would result in little or no competition in the intraLATA marketplace because, under the Plan, NYNEX would

[140] AT&T argues that NYNEX should impute access charges in the provision of its own toll services because an end-to-end toll service provided by NYNEX involves the same access service as the one provided by its competitors (AT&T Brief at 45).

[141] Optional Calling Plans are services, such as NYNEX's premium toll services, that bundle basic exchange services and toll service offerings together.

not be required to comply with the various pricing rules when introducing a new service, as long as it does not change the rate for the service in an annual filing (id. at 46-47).

AT&T claims that NYNEX's argument that carrier access rates under the Plan are consistent with the Department's decision in D.P.U. 89-300 is without merit because the findings in that Order were based on a ROR regulation scheme that requires periodic review of the costs on which rates are based (AT&T Reply Brief at 14). AT&T contends that NYNEX's Plan is a move away from the decision in D.P.U. 89-300 that requires cost-based pricing of monopoly services and, accordingly, access charges set under ROR regulation should not be "given a binding effect under a price cap regulatory scheme that insulates such a determination from reconsideration for ten years" (id.). AT&T argues that, under the Plan, NYNEX would be free to increase access prices after target levels have been reached, thus distorting competitive markets and causing significant economic damage (AT&T Brief at 40-41).

AT&T maintains that the current and target access rates "far exceed" the cost of providing access service (id. at 41). According to AT&T, while a reduction of 47 percent is required to achieve an equalized rate of return for the access customer class, a move to target level would only reduce the rate by 30 percent; thus resulting in the Department's acceptance, under the

Plan, of a switched access rate that is "significantly" higher than the cost of providing the service (id.).

iv. MCI

MCI recommends that the Department immediately set switched access rates in the eastern LATA at their 1990 target rates and revisit those rates after NYNEX provides the Department with TSLRIC cost studies (MCI Brief at 9). According to MCI, because switched access rates represent a major cost item for interexchange carriers, any plan that would allow NYNEX to increase access rates, when they are already above their cost, would be anticompetitive and inconsistent with the Department's pricing goals established in D.P.U. 89-300 (id. at 18). MCI argues that, if the Department finds that the target rates are not excessive, the Department should at least require NYNEX to set the rates at their target level at the beginning of the Plan and should not allow NYNEX to raise them once target rates are achieved (id.).

MCI argues that the Department should establish a proper competitive framework before implementing alternative regulation for NYNEX (id. at 3). MCI asserts that NYNEX should be required to impute the rates that it charges its competitors in setting its retail service rates, including local exchange rates (id. at 5).

MCI argues that the switched access target rate has no relation to the cost of providing the service because the target rate, while lower than the current rate, would still be 300 percent above cost [142] (id. at 9). Such rates are, according to MCI, contrary to the telecommunications policy established in D.P.U. 1731 and provide evidence that NYNEX continues to extract monopoly profits from carrier access customers (id. at 9, 11). MCI contends that, because NYNEX is experiencing continuous cost reduction made possible through network improvements, such as digital switching, the Company's customers, including MCI, are entitled to a portion of those cost reductions (id. at 9).

Furthermore, MCI argues that the $0.011 per minute differential between toll and access rates, as proposed in the Plan, is deceptive in nature and does not prevent NYNEX from engaging in anticompetitive pricing practices because the Company could violate the differential at any time between the annual filings by raising rates or introducing optional calling plans that would lower toll rates (id. at 21). MCI asserts that the Department should require NYNEX to maintain the differential at all times and that any deviation from the differential should be grounds for suspension of the tariff (id. at 23).

Moreover, MCI argues that NYNEX's toll services should

[142] MCI asserts that, according to the Company, while the current cost of providing end-to-end switched access service is about $0.014 per minute, the peak period charge to competitors is about $0.056 (MCI Brief at 9).

include access charges and any other non-access incremental costs incurred in providing that service (id. at 24). MCI maintains that requiring imputation of access services on a service-by-service basis would allow for "changes in the imputation calculation while maintaining protection against price squeezes" (id.).

v. FEA

FEA argues that moving switched access rates to their target levels as soon as possible would contribute to the competitive environment provided that all rates are set at their target levels, including the basic residential rates that the Company proposes to freeze at current levels (FEA Brief at 5, 7).

b. Analysis and Findings

In D.P.U. 89-300, the Department found that it was necessary to link NYNEX's retail (toll) and wholesale (access) rates. D.P.U. 89-300, at 217. This linkage was accomplished by requiring that the Company's average per minute toll rate exceed the average per minute access rate by at least $0.007756. Id. at 203-204, 217. In addition, the Department required the Company to move switched access rates to their target levels over time in the annual transition filings, rather than price access rates directly at the target level as a result of that Order. Id. at 217.

In its petition for approval of its price cap Plan, the

Company proposed to (1) reduce switched access rates to the target level established in D.P.U. 89-300 by the second annual price cap filing, and (2) maintain a minimum differential of $0.011 between the average switched access rate and the average NYNEX toll rate, but only at the time of an annual filing. However, as noted, AT&T and MCI argue that the current and target access rates are unreasonable because they create a price squeeze for competitors, which inhibits competition with NYNEX in the intraLATA toll market. They further argue that this price squeeze will be exacerbated under NYNEX's proposed Plan.

First, regarding the Company's planned reductions in access rates, the pricing flexibility granted to NYNEX in this Order provides the Company the incentive and the ability to achieve economically-efficient rates for its toll service. With the link described below between toll and access rates, any reduction in toll rates will force the Company to lower access rates as well (see Tr. 2, at 137). We find the Company's specific timetable for reducing access rates to their target levels by the second annual price cap filing to be reasonable because the goal of the transition process with regard to access rates thus will be achieved in a similar timeframe. [143] Also, we find that it is

[143] Although we have approved the Company's proposal to end the transitional rate-rebalancing process, it is reasonable for the Company to commit to a similar schedule for achieving the target access rates, in order to mitigate concerns about (continued...)

appropriate to apply the REI to access rates after the second annual price cap filing because, as described, supra, in Section VI.C.2.b, the REI promotes the achievement of economically-efficient rates. Because access rates and toll rates will be linked, as described below, there should be no incentive for the Company to raise access rates (assuming that current rates are above the economically-efficient level) because NYNEX would then be forced to raise its own toll rates.

Regarding the alleged price squeeze, we do not agree with the IXCs' assertion that the link between access and toll rates should be eliminated and that access rates should be set directly at marginal cost. We have noted several times in this Order that we remain committed to the goal of achieving an economically efficient rate structure in telecommunications. However, the evidence in this case indicates that the economically efficient rate for access service is not necessarily equal to the marginal cost of the service. [144]

[143] (...continued) anticompetitive pricing.

[144] The evidence indicates that the cost structure for telecommunications is such that the firm's total costs are not recovered when prices are set at marginal cost (see Tr. 2, at 129-130). Therefore, the economically efficient rate under these conditions is achieved when prices are set such that the relative demand for each service is the same as it would have been under marginal-cost prices, i.e., the economically-efficient rate structure in telecommunications is the outcome of Ramsey Pricing (id. at 130-131).

While we find it appropriate to continue to link toll and access rates, the record in this case requires us to reexamine the retail/wholesale rate relationship established in D.P.U. 89-300. We find that the link between toll and access rates should be, at a minimum, consistent with our findings in Section VI.C.1.b.ii, _supra_, regarding the proper price floor for NYNEX's services. As noted, where NYNEX controls an essential input for a competitor's offering of a service (which is clearly the case for switched access), we found that the proper price floor for NYNEX's retail rate shall consist of the relevant wholesale rate that at least one competitor pays to NYNEX in order to offer the service, and NYNEX's marginal cost of related overhead. Therefore, at a minimum, this price floor requires that NYNEX's toll rates exceed the relevant access rate plus NYNEX's marginal cost of related overhead.[145] However, we are persuaded by the arguments of AT&T and MCI that it is no longer appropriate to base this differential on the average access rate and the average toll rate, as was done in the transition process. Basing the toll-access link on average rates is inappropriate in this increasingly competitive market because NYNEX could then price anticompetitively for specific customers and/or services

[145] We agree with AT&T that related overhead should include marketing and advertising costs; therefore, the Company's proposed differential of $0.011 should be increased to include such costs.

while still maintaining the proper differential on average.[146] Accordingly, NYNEX shall be required to comply with the price floor described above on a service-by-service basis. Consistent with our findings in Section VI.C.1.b.ii, supra, the Company shall include with its initial price cap filing a computation of the proper price floor for switched access and for its own toll services. Other parties then will have the opportunity to comment on whether the proposed price floor is correct.

With regard to NYNEX's argument that anticompetitive pricing should not be a concern because (1) the Company is not proposing to price anticompetitively, and (2) competitors have a forum at the Department to complain about anticompetitive pricing, such assertions run directly counter to the underlying intent of price cap regulation. A price cap is intended to create a regulatory system that responds to the regulated firm's incentives, and not to its publicly-asserted intent. A profit-maximizing firm with market power, such as NYNEX, has an incentive to price anticompetitively; therefore, it is necessary to prevent NYNEX from doing so by adopting a price floor, notwithstanding the Company's stated intent not to price anticompetitively.

[146] If, as the Company suggests, the retail costs or related access rates vary among services and customers, the Company should have a separate tariffed rate for that service or customer (as it does under its Customer Specific Pricing tariff), but it must demonstrate that the rates for that service or customer comply with the relevant price floor.

For purposes of this Order, the Company shall link its toll and access rates in compliance with the price floor directives described in Section VI.C.1.b.ii, supra. While we find that this price floor represents the appropriate minimum differential between NYNEX's toll and access rates, we are not certain that it represents the best interconnection pricing policy for ensuring that competition for intraLATA toll develops on an economic basis in Massachusetts.[147] A determination of the proper relationship for retail and wholesale rates, if in fact it differs from the price floor described in this Order, will be made in the Department's local competition docket, D.P.U. 94-185, already underway.

With regard to premium services and optional calling plans, the record indicates that many of these premium services are provided to residential customers at prices below the average access charge that IXCs would have to pay NYNEX. Therefore, it is not economically feasible for IXCs to compete for these customers. As noted in Section VI.C.1.b.ii, supra, the Company is required to comply with the price floor by the second annual price cap filing. The issue of whether a price squeeze involving premium calling plans still exists will be addressed at that time, at the latest, if not in the local competition docket.

[147] Our goal in this regard is to ensure that the job of carrying intraLATA traffic will go to the most efficient carriers.

D. Streamlined Tariff Review

Under the Plan, although the Company may only increase current rates at the time of the annual filings, the Company would make tariff filings to introduce new services, or reduce prices of existing services, between annual filings (Exh. NYNEX-1, at 17-18). These filings would not include any price increases, but would be subject to a "streamlined" tariff review procedure (id. at 18). The Company would not be required to provide cost support for its new service or price reduction filings, but only demonstrate that the filed tariffs comply with the pricing rules (id.). According to the Plan, suspension of these tariff filings would be allowed only if the Company does not comply with the pricing rules, or for reasons related to privacy, public safety, or any conflict with the Department's regulations such as billing and collection rules applicable to residential customers (id. at 19).

The Department could undertake an investigation into a proposed tariff filing if claims of anticompetitive behavior are made, and the burden of proof would rest with the party making the claim (id. at 19-20). According to the Plan, a tariff filing would be judged anticompetitive only if the service is priced so that incremental revenues are less than the incremental costs of the service (id. at 20). Also, the tariff could not be suspended unless the Company made a request to suspend during an investigation (id.).

1. Positions of the Parties

a. NYNEX

NYNEX maintains that its proposal for a streamlined tariff review process to introduce new services and reduce prices for existing services provides an administratively efficient process while fully protecting the interests of the Company's customers and competitors (NYNEX Brief at 75).[148] The Company argues that, unlike the current framework in which NYNEX may propose increases in any service at any time, the Company forgoes its ability under the Plan to increase prices at any time, as the Plan allows price increases only at the time of the annual filing (id.).

Regarding the issue of cost support for tariff filings, NYNEX maintains that comprehensive filing requirements are unnecessary and a waste of resources (NYNEX Brief, App. B at 27). The Company contends that cost data support is not necessary since the pricing rules are designed to assure just and reasonable rates (id. at 26). The Company argues that if a party should challenge a tariff and the Department opens an investigation, the necessary cost support would be provided, but that the tariff should not be suspended during the investigation

[148] Under NYNEX's Plan, the Company is required to continue to offer all of the services provided under tariff as of the date of Department approval of the Plan, unless it petitions the Department for withdrawal of a service (Exh. NYNEX-4, at 8).

(id. at 27).[149] The Company states that the sole criterion for any allegation of anticompetitive pricing would be that incremental revenues do not cover incremental costs (Exh. NYNEX-4, at 7).

b. Attorney General

The Attorney General maintains that the Department's current tariff review procedures should be modified by applying the Attorney General's proposed pricing rules (see Section IV, supra) (Attorney General Brief, Part I, at 24, citing Exh. AG-796).

c. AT&T

AT&T argues that NYNEX should be required to submit with proposed tariff changes "minimally sufficient supporting data to demonstrate that its proposed rates in fact cover relevant imputed access costs plus total service long-run incremental costs of the proposed service" (AT&T Brief, App. B at 9). AT&T argues that, although the Plan allows competitors to challenge a filing on the ground that the incremental revenues do not exceed the incremental costs, competitors are put at a disadvantage because (1) NYNEX is permitted to put the service into effect during an investigation; (2) the burdens of supervision and enforcement fall on the competitors; and (3) competitors will not

[149] The Plan provides for suspension of tariffs if the Company does not comply with the pricing rules, and for reasons of privacy, public safety, and any conflict with Department regulations (Exh. NYNEX-4, at 8).

know when to make a challenge because, although each individual rate change may produce de minimus results, the cumulative result would be material (id. at 38-39).

AT&T maintains that the Company's provision of cost information only after a competitor's challenge would impair significantly a competitor's ability to make such a challenge (AT&T Reply Brief at 18). AT&T contends that with such a factual dispute regarding NYNEX's costs built into any anticompetitive challenge, NYNEX will have ensured that its competitors face an arduous task to succeed on an anticompetitive challenge (id. at 19).

d. MCI

MCI argues that NYNEX's Plan provides inadequate procedures to challenge the Company's pricing practices and tariff filings (MCI Brief at 25). MCI maintains that the standard for determining what is anticompetitive is too narrow and does not prevent NYNEX from cross-subsidizing its services and engaging in price discrimination (id.). Further, by not requiring NYNEX to include any cost support with its tariff filings, MCI contends that the Company's Plan shifts the burden of proof onto the complainant (id. at 26). Moreover, MCI maintains that since the tariff would remain in effect until the complainant demonstrates the anticompetitive impact, NYNEX has an incentive to engage in dilatory tactics, thereby further increasing the costs of litigation, resulting in a costly or ineffective process (id. at 27).

e. NECTA

NECTA contends that the Company's Plan unduly restricts the Department's authority to suspend and investigate tariffs (NECTA Brief at 48). NECTA argues that NYNEX's proposed streamlined tariff review (1) removes NYNEX's burden to prove a rate is reasonable, (2) places on consumers and competitors the burden of disproving the reasonableness of the rate, and (3) eliminates from Department consideration a variety of factors that could bear upon the reasonableness of the rate (id. at 49). NECTA maintains that the Department would be remiss if it so limited its future authority over NYNEX and effectively watered down the extensive regulatory power delegated to it by the legislature (id.).

2. Analysis and Findings

Because we have established a price floor for NYNEX's services (see Section VI.C.1.b.ii, supra), we find that it is necessary for the Company to provide information with its tariff filings to demonstrate that the Company's proposed rate exceeds the relevant price floor.[150] We agree with AT&T that requiring

[150] With regard to the specific filing requirements, NYNEX shall provide with each of its tariff filings the following information: (1) the price floor, and (2) the required marginal cost and access information for the proposed price

(continued...)

the Company to provide such information only after a party's challenge would be unreasonable and inefficient. Without any cost support, it would be unnecessarily difficult, if not impossible, for competitors and the Department to determine whether the proposed tariff filing properly meets the price floor requirement. We disagree with the Company's claim that because other parties compete in the same industry, they should have sufficient information of NYNEX's costs to determine whether a filing is anticompetitive.

Pursuant to G.L. c. 159, § 19, changes in existing tariffs or the introduction of new services by tariff may take effect only after 30 days from the date of filing, unless the Department finds good cause for a shorter period. When a new tariff or tariff revision is filed, the Department has the authority to suspend the operation of the proposed tariff for up to six months to allow for an investigation into the justness and reasonableness of the rates, terms, and conditions. G.L. c. 159, § 20; G.L. c. 25, § 18. See also New England Tel. and Tel. v. Department of Pub. Utils., 376 Mass. 28, 31-32 (1978).

We find that it would be inappropriate for the Department to relinquish its authority to suspend the effective date of a tariff during investigation. The Department's approval of price

[150] (...continued)
floor.

cap regulation for NYNEX does not diminish any regulatory responsibilities imposed pursuant to statute. The Department must be able to exercise its judgment in determining whether a tariff filing reducing rates for existing services or introducing a new service warrants suspension and investigation. Also, we agree with the intervenors that NYNEX would have an unfair advantage if it could introduce services and keep those services in effect while complaints are resolved. Accordingly, while we will allow NYNEX to request that specific tariff filings be allowed to go into effect pending investigation, the Department will exercise its discretion to grant such requests on a case-by-case basis, taking into account, inter alia, privacy, public safety, and compliance with Department regulations and the pricing rules of the price cap plan.[151]

Consistent with the findings above on adopting a price floor for NYNEX's services, the Department finds that the proper criterion for judging whether a NYNEX filing is anticompetitive is to determine whether NYNEX's proposed rate exceeds the relevant price floor. A showing by NYNEX that the proposed rate exceeds the relevant price floor would be prima facie evidence that it is not anticompetitive.

[151] If NYNEX is correct that it is in the Company's self-interest to price tariffs at the correct starting point to avoid introducing a service, only to later be forced to modify or withdraw it, a large number of tariffs may not have to be suspended.

Regarding the Company's proposal to continue offering all services under tariff as of the date of this Order during the full term of the price cap plan, we find that such a commitment is reasonable because it provides an assurance to ratepayers that service options will not be reduced during the term of the price cap plan.

E. Lifeline Discount

Under the Plan as proposed, the Company would increase the Lifeline discount by $2.50 per month within 30 days following approval (Exh. NYNEX-1, at 21). In addition, the Company would not propose any decrease in the Lifeline discount until its annual filing in 2001, at which time the discount becomes subject to the pricing rules of the Plan (id.).

1. Positions of the Parties

a. NYNEX

NYNEX asserts its proposed Lifeline credit is reasonable in that the "increase is designed to further the Department's goal of universal service" (NYNEX Brief, App. B at 29).

b. Attorney General

The Attorney General asserts that NYNEX's proposed $2.50 increase to the Lifeline discount is not high enough (Attorney General Brief, Part I, at 100). The Attorney General argues that the credit has been frozen for the past five years and that "because of substantial rate increases in the last five years, Lifeline customers are now paying more for local service than they did when Lifeline was installed" (id.).

The Attorney General notes that in D.P.U. 93-125, the Department ordered the Company to review its Lifeline program to determine the adverse effect of increases in residential exchange rates on universal service as a basis to determine whether there should be additional adjustments (id.). The Attorney General states that "[NYNEX] apparently elected to propose price caps and seek a waiver of the [t]ransition[al] filings instead of providing the data [that] the Department requested ..." (id. at 101).

The Attorney General asserts that NYNEX only proposes an increase in the Lifeline credit to eliminate the April 1994 residential rate increase resulting from the Department's decision in D.P.U. 93-125, without justification for the amount of the increase (id.). The Attorney General states that NYNEX's proposed $2.50 Lifeline credit increase would only apply for the next six years, and then the discount would be subject to NYNEX's pricing rules (id., citing Exh. NYNEX-1, at 21). The Attorney General further argues that the flexibility within NYNEX's pricing rules may prevent any rate reduction for Lifeline customers for six years, and that the $2.50 credit proposed by NYNEX could be "stripped away" during the remainder of NYNEX's Plan (id.).

The Attorney General suggests the Department order NYNEX to increase the Lifeline Credit more than $2.50 and to comply with the directive in D.P.U. 93-125 within six months of the date of this Order, to determine the impact on universal service of any future proposed Lifeline rate increases (id. at 102).

2. Analysis and Findings

The Lifeline program was developed in Massachusetts, in conjunction with a similar federal program, to promote universal service. In the most recent NYNEX transitional rate proceeding, the rate for residential dial-tone service was increased by approximately $2.50 per month. See D.P.U. 93-125, at 20.

The Department finds that the proposed $2.50 increase in the Lifeline discount, in conjunction with the proposed freeze on basic residential rates for the six-year term that we approve in this Order (see Section VI.C.5.b, supra), is reasonable because it promotes adequately the Department's goal of universal service. Since the proposed rate freeze will continue for the term of the price cap plan, the Attorney General's concern about the impact of the other pricing rules on the Lifeline discount has been addressed.

The Department has found that, prior to the last increase in the dial-tone rate, the rate-rebalancing proceeding has had no negative effect on universal service. See D.P.U. 93-125, at 58. However, the Department also expressed its concern in

D.P.U. 93-125 that additional increases in the residential dial-tone rate required to reach the target rate not negatively impact universal service. Id. at 59. In this proceeding, the Company has proposed an increase in the Lifeline discount to cancel out the dial-tone line rate increase approved by the Department in D.P.U. 93-125, thus effectively rolling back the rates for Lifeline customers to the point at which the Department found that there had been no negative effect on universal service. Therefore, the Company's proposed increase in the Lifeline discount allays the Department's expressed concern in D.P.U. 93-125 regarding universal service. There is no evidence in this case to support the Attorney General's recommendation for a further increase in the Lifeline discount above the level proposed by the Company. For the reasons cited above, we find that the Company's proposed increase in the Lifeline discount is reasonable and is therefore approved.

With regard to the Department's direction for a review of the Lifeline program, the Attorney General correctly notes that in D.P.U. 93-125 the Department ordered the Company to report on five issues related to universal service, including "the expected affordability of phone service for low-income customers at target rates." D.P.U. 93-125, at 60. However, because the issue of universal service funding is a component of the Department's investigation into local competition (D.P.U. 94-185), we find that any change in methods for achieving universal service can be addressed more appropriately in that docket. Therefore, it is not necessary to direct the Company to provide the impact analysis described in D.P.U. 93-125.

F. Depreciation Flexibility

Under its proposed Plan, NYNEX would have discretion to adjust its depreciation rates, provided that the lives used to determine those rates shall not be greater than the lives prescribed by the FCC (Exh. NYNEX-1, at 21-22).

1. Positions of the Parties

a. NYNEX

The Company maintains that it should be allowed to maintain the depreciation flexibility it currently has under ROR regulation, which, according to NYNEX, means that the Company may change its depreciation rates as long as they are, at a minimum, the rates established by the FCC in the triennial review process (NYNEX Brief, App. B at 20). The Company argues that if it "is not permitted the continued flexibility to recover its investment in a more realistic and timely manner, that better reflects the economic use of the assets, then this may hinder the Company's ability to make efficient investments in new technologies and offer new services to satisfy customer needs" (NYNEX Brief at 99).

NYNEX cites two reasons that depreciation flexibility, with lives not to exceed the levels established by the FCC, is a reasonable approach: (1) the Company will have more funds to invest in its network, and (2) depreciation flexibility will reduce the Company's risk that its investment costs will not be fully recovered (id.). NYNEX argues that both of these factors will increase its incentive to invest in new technology (id.).

b. Attorney General

The Attorney General argues that the Department should "fix" depreciation rates for the duration of an alternative form of regulation, regardless of whether earnings sharing is adopted (Attorney General Brief, Part I, at 89). The Attorney General asserts that the Department will at some point need to evaluate the performance of NYNEX under alternative regulation, and, if the Company is allowed to establish its own depreciation rates, it will be impossible for the Department to determine whether adjustments to the alternative regulation plan are necessary (id. at 89-90).

The Attorney General also maintains that NYNEX has an incentive to adjust depreciation rates to "evade disclosing excessive earnings," regardless of whether earnings sharing is adopted, because if earnings become excessive under the Plan, the Company would face pressure from the Department and others to modify the parameters of the Plan (id. at 90). The Attorney General argues that NYNEX should not be granted flexibility to establish depreciation rates unilaterally under an alternative form of regulation (id. at 22). The Attorney General maintains that his proposed earnings sharing/cap mechanism with fixed depreciation rates would provide an instrument to: (1) reduce administrative burdens that would result from complaints that rates are too high; (2) maintain just and reasonable rates; and (3) take away the Company's incentive to adjust depreciation rates when earnings are excessive (id.).

c. AT&T

AT&T argues that NYNEX should not be granted flexibility to establish depreciation rates unilaterally under an alternative form of regulation (AT&T Brief, App. B at 7). Otherwise, according to AT&T, the earnings constraints that are a necessary component of a price cap plan would become meaningless because the Company could adjust its depreciation rates to determine the level of earnings it wishes to achieve during a relevant period (id.).

d. MCI

MCI argues that NYNEX should not be granted flexibility to establish depreciation rates unilaterally under an alternative form of regulation because, by "deregulating" depreciation rates, the Department would put NYNEX in a position to manipulate its earnings and cash flow (MCI Brief at 37).

2. Analysis and Findings

NYNEX is currently allowed flexibility to adjust its intrastate depreciation rates; however, in the event of a rate case, the issue of depreciation cost recovery would be determined by the Department. As noted, in its petition for price cap regulation, the Company proposed to maintain its flexibility to adjust depreciation rates, with the additional commitment by the Company to use depreciation lives that would not exceed the levels established by the FCC in the most recent triennial represcription. We find that allowing NYNEX the flexibility described above to adjust its depreciation rates is consistent with the economic rationale underlying price regulation. Under the price cap we approve for NYNEX in this Order, the Company will assume all risk for bad investments (see Section V.C, supra). Since the Company bears that risk, we find that it is reasonable that the Company have the discretion to adjust its depreciation rates, particularly with the Company's commitment to use depreciation lives that would not exceed those set by the FCC.

With regard to the parties' argument that the Company could use depreciation flexibility to mask excessive earnings, and thus avoid sharing excess earnings, as noted in Section VI.B, supra, the Department has rejected adoption of an earnings sharing mechanism in its price cap for NYNEX, and, therefore, this concern is no longer relevant.

The Attorney General also argues that the Company should not be granted depreciation flexibility even if the Department does not adopt earnings sharing, because the Company could use such flexibility to avoid reporting excessive earnings and thus prevent "pressure" from the Department and others to modify the Plan. As such, the Attorney General raises the issue of re-examining the price cap plan and recontracting. In order to maximize economic incentives in a price cap plan, a regulated entity should be allowed to operate under the terms of the price cap without the risk of recontracting by the Department (see Section V.A.2.b.iii, supra). Therefore, the Department has limited the criteria for a petition to modify any of the terms or conditions of the price cap plan to: (1) reflect the impact of federal or state legislation or court decisions enacted or issued subsequent to the Department's approval of the plan; or (2) seek a less structured form of regulation or deregulation of NYNEX's operations based upon changes in market conditions. Because the level of the Company's earnings is not one of the aforementioned criteria, the Company should have little incentive to use its depreciation flexibility for any purpose other than to retire its capital in the most efficient and cost-effective manner.

For all of the reasons cited above, we approve NYNEX's proposal for depreciation flexibility. We note that granting the Company depreciation flexibility will not affect the Department's ability to evaluate the effectiveness of price cap regulation for NYNEX at the end of the plan's term because the Department will be able to review the reasonableness of the Company's depreciation at that time, in the same way that it does now in a rate case, e.g., our approval of depreciation flexibility does not represent "pre-approval" of the Company's depreciation rates for ratemaking purposes.

F. Term of the Price Cap Plan

NYNEX proposes a minimum ten-year term for the Plan (Exh. NYNEX-1, at 10). Under the Attorney General's proposed price cap plan, the plan would be in effect for three years and may be extended for additional three-year periods at the Company's election (Exh. AG-796, at 2).

1. Positions of the Parties

a. NYNEX

The Company concludes that with the inclusion of the necessary components to ensure just and reasonable prices, a ten-year term is appropriate (NYNEX Brief, App. B at 21). The Company disagrees with the Attorney General's proposal for a term of three years, arguing that such a term is insufficient to provide the correct economic incentives (id. at 95). The Company further disagrees with the Attorney General's recommendation of a periodic review process (id.). The Company argues that the Attorney General's suggested review process is not streamlined but would instead permit intervention, discovery, cross-examination, and "potentially extensive and prolonged litigation" (id. at 96, citing Exh. NYNEX-37, at 25). The Company further argues that this is unnecessary as its annual filings will demonstrate whether it is in compliance with the Plan's requirements (id. at 96-97).

The Company states that NECTA's support of the Attorney General's proposal for periodic reviews by relying on FCC procedure on the AT&T price cap regulation plan is misplaced (id. at 96-97). The Company states that AT&T's annual filings are pro forma and not as detail intensive as the Attorney General's proposal (id. at 97). Further, the Company states that even though there is an opportunity for comment, there is no formal investigation or litigation in the FCC's price cap review (id. at 97).

b. Attorney General

The Attorney General argues that the Company's proposed ten year term for the price cap plan is clearly too long a time without re-evaluation of the critical assumptions of the plan (Attorney General Brief, Part I, at 27). According to the Attorney General, the duration of time that any plan could be in effect without Department review is a critical element as to whether such plan is in accord with the Department's statutory authority under G.L. c. 159 (id.).

The Attorney General argues that any price cap plan is predicated implicitly on assumptions concerning cost and productivity conditions, as well as on assumptions concerning the level and vigor of competition (id. at 28). The Attorney General asserts that if the Company's costs do not increase as much as is contemplated in the Plan, for reasons having nothing to do with specific management initiatives, the built-in automatic price adjustments would produce excessive prices relative to actual costs and would result in excessive profits and rate levels that are unjust and unreasonable (id. at 28, citing Exh. AG-795, at 70-71).

The Attorney General concludes that it would be "poor public policy" to approve any plan that does not provide for review at least every three years (id. at 29). The Attorney General also proposes "ongoing monitoring and review" that is linked to the term of the plan (Exh. AG-795, at 124).[152] The Attorney

[152] Under the Attorney General's proposal, the evaluation and performance criteria for this ongoing monitoring and review are: (1) NYNEX's earnings, overall and by service baskets; (2) price movements for services in each category, and relative to the overall inflation rate; (3) realized productivity changes; (4) deployment of new technology and new services that are based on new technology, prices being charged for these services, and rates of penetration being achieved; (5) growth of actual competition for services classified as "competitive" measured in terms of market shares, price movements, entry of new providers, and other measures; and (6) quality of NYNEX's non-competitive services and response to customer complaints (Exh. AG-795, at 124).

General suggests that if the Department adopts an earnings sharing mechanism and constrains the ability of NYNEX to adjust depreciation rates, then the Attorney General argues that this review should be made after the third year of the plan; otherwise, the review should be held after the second year (id. at 125).

c. AT&T

AT&T argues that the ten-year duration proposed by the Company could do "serious and irrevocable damage" to the development of competition in Massachusetts (AT&T Brief at 47). AT&T argues that the compounding of permissible rate increases, the ability to shift costs between competitive and non-competitive services, and the ability to "bank" permissible rate increases all combine so that a small mistake in the appropriate productivity offset could lead to catastrophic consequences (id. at 47-48). Therefore, AT&T concludes that the price cap plan should allow for no more than a three-year period before providing an opportunity to revisit it and to make any mid-course corrections (id. at 48).

d. MCI

MCI states that it is unaware of any other jurisdiction, federal or state, that has adopted a LEC alternative regulatory plan equivalent in length to the Company's proposed ten-year duration (MCI Brief at 32). MCI notes that there are many factors accelerating change in the telecommunications industry, such as federal legislation, new technology, new entrants into the telecommunications market, growth of consumer demand, the convergence of the computer, telephone, and cable industries, and the building of the information superhighway (id. at 32-33). MCI argues that all of these dynamic changes make it unlikely that the market conditions over the next ten years will mirror the assumptions upon which the Company bases its plan (id. at 33).

Therefore, MCI concludes that if the Department adopts the Company's plan, the duration should be limited to no more than three years (id. at 34).

e. NELF

NELF maintains that a new form of regulation "should incorporate internal mechanisms that will automatically trigger reconsideration of still further structural changes" (NELF Reply Brief at 2). NELF argues that it is doubtful that any one term is "either necessary or wise" because "different components of a price cap will be differently affected by external developments not captured by any adjustment for `exogenous factors'" (id. at 3).

2. Analysis and Findings

The Attorney General and other intervenors have cited no legal authority to support their claim that without a review after three years, the Department would be "abdicating" its statutory authority and thus the plan would be unlawful. And, relating to AT&T's concern about a longer-term plan hindering the development of competition, there is no evidence to suggest that. Therefore, we find that there is no legal impediment to approving a term longer than three years for a price cap plan.

We do not agree with intervenor claims that a three-year term is necessary to compensate for the necessity of making predictions about future costs and productivity (see n.97, supra, discussing the need to make predictions in ROR regulation). The Department's analysis in adopting the 4.1 percent productivity offset is based on statistically-robust long-term averages for TFP growth and input prices. Therefore, we are confident that it should prevent monopoly pricing and produce just and reasonable rates throughout the term of the plan.

In addition, we find that a well-designed price cap plan should be of sufficient duration in order to provide NYNEX with the appropriate economic incentives and certainty to allow the Company the confidence to make and follow-through with medium- and long-term strategic business decisions. A three-year term likely would not provide the proper incentives, particularly if there is the possibility that the Department could discontinue price cap regulation and revert to ROR regulation. In addition, given the significant annual variability in average productivity and input prices, it is unlikely that the Department would be able to make any substantive conclusions about the proper productivity offset based only on a three-year experience.

We find that it would be appropriate to begin review of the price cap after six years to coincide with the end of the Company's proposed basic residence rate freeze (see Section VI.C.5, supra). Accordingly, the price cap plan approved by the Department in this Order will be in effect at least until August of 2001.[153] at that time, the Company may petition for continuation of the Plan, and if the Company files no such petition, or the Department rejects such a petition, the Department will initiate a review of the appropriate form of regulation for NYNEX.

VII. EARNINGS REVIEW

A. Introduction

1. Background

An important step in developing a well-designed price cap is determining just and reasonable rates for the starting point under price regulation. If NYNEX's aggregate rates reflect more than a reasonable level of revenues and expenses at the initiation of the price cap, the Company could earn monopoly profits under price cap regulation as a result of a revenue

[153] In addition, we disagree with the Attorney General's recommended "monitoring and review" standards. His monitoring and review recommendations go well beyond even the current level of ongoing review under ROR regulation.

surplus embedded in aggregate rates at the start of the plan. As noted in Section V.A.2.b.i, supra, as long as NYNEX is not receiving monopoly rent at the start of the price cap plan, the price cap formula will ensure that earnings will be reasonable over time.

2. Scope of Earnings Review

On April 14, 1994, along with its Alternative Regulatory Plan, NYNEX filed direct testimony of Edward J. McQuaid, NYNEX managing director of finance, to demonstrate that the Company's current rates are an appropriate starting point for the Plan. His testimony dealt with cost of service and rate base issues.

On June 14, 1994, in response to a number of motions related to the scope of the proceeding, the Department found that it would be necessary to conduct an "earnings review" in order to determine whether NYNEX's current rates are the appropriate rates for the starting point for a price cap form of regulation. June 14, 1994 Interlocutory Order at 22. The earnings review, rather than a full rate case, i.e., a review of the Company's revenue requirement, cost allocation and rate structure, would assess the continued appropriateness of the D.P.U. 86-33-G earnings level. Id. at 22-23. The Department found that the earnings review would assess the reasonableness of the Company's current level of earnings, as supported by the testimony of Mr. McQuaid and the financial information accompanying his testimony. Id. at 13-14, 22.[154] The Department noted that if, based on its earnings review, it appeared that current rates were not the appropriate rates for the starting point for a price regulation plan, the Department might conclude that a more detailed review in a subsequent proceeding would be necessary. Id. at 22.

On July 14, 1994, in response to requests from parties for clarification on the scope of the earnings review, the Department issued an Interlocutory Order expanding the scope of the earnings review. It stated:

> the scope of inquiry into the reasonableness of NYNEX's current earnings as an appropriate starting point for the Plan will be as follows: (1) any matter concerning the reasonableness of the current level of earnings, including the Company's study period expenses, revenues, and investment, may appropriately be the subject of inquiry by parties in this proceeding either through cross-examination or by presentation of direct testimony by intervenors, jointly or severally; and (2) any party may seek to rebut the presumption that the Company's currently adjudicated and authorized rate of return is prima facie reasonable.

July 14, 1994 Interlocutory Order at 7.[155]

[154] The Department had stated in that Interlocutory Order that the earnings review would encompass an examination of whether: (1) the adjustments prescribed by the Department in D.P.U. 86-33-G have been properly reflected in the test year account balances presented in NYNEX's filing; and (2) the resulting rate of return on investment is reasonable. June 14, 1994 Interlocutory Order at 22.

[155] In this respect, the Department clarified that while the Company's allowed rate of return was prima facie reasonable because it was fully adjudicated and found reasonable in D.P.U. 86-33-G, the Department would examine whether that (continued...)

As such, the Department allowed intervenors to investigate all relevant matters concerning the Company's revenues, expenses, investment, and ROR. This opportunity enabled parties to explore adjustments other than those addressed by the Department's Order in D.P.U. 86-33-G and to propose a different ROR. Id. at 14-15. In addition, the Department again noted that if it found that NYNEX's current rates were not the appropriate rates for the starting point for a price regulation plan, further proceedings might be necessary. Id. at 8. In addition, the Department confirmed that the burden of proving the reasonableness of the Company's current level of earnings as an appropriate starting point for the Plan remained with the Company. Id. at 18. The Company would have the burden of showing that (1) the Company's current allowed ROR is reasonable by today's standards, and (2) the Company is not currently earning more than a reasonable ROR (see July 14, 1994 Interlocutory Order at 7) -- in other words, that the adjudicated result in D.P.U. 86-33-G, as it has developed over time, remained valid as the starting point for price cap regulation.

Thus, the Department's earnings review was an inquiry into the reasonableness of the Company's current earnings as an

[155] (...continued) allowed rate of return was still reasonable in light of today's investment climate, and if not, then what would be a reasonable rate of return.

indicator of whether current rates are appropriate as rates for the starting point under price regulation, or whether an additional investigation is necessary. Implicit in our determination to conduct an earnings review was the recognition that while the Company's litigated current rates are "deemed *prima facie* lawful" and presumptively reasonable until changed or modified by the Department (*see* G.L. c. 159, § 17; D.P.U. 93-125), those rates might not be the appropriate rates for the starting point under price cap regulation, should it appear that the Company was earning more than a reasonable return. If, based on the results of the earnings review, it appeared that the Company's revenue requirement -- last adjudicated in D.P.U. 86-33-G and reflected in the current rates approved in D.P.U. 93-125 -- might be producing a level of overearnings, then the reasonableness of those rates as rates for the starting point under price regulation could be in doubt. In that case, the July 14, 1994 Interlocutory Order envisioned possible further proceedings.

The Department provided parties with the full opportunity to explore all issues related to the Company's earnings. Intervenors were given the opportunity to examine and challenge all relevant aspects of the Company's filing, including revenues, expenses, and investment, and also were allowed to present evidence to rebut the presumption that the Company's currently adjudicated and authorized rate of return is prima facie reasonable. However, issues related to cost-allocation and rate structure were beyond the scope of the earnings review.[156]

On July 28, 1994, in response to the Department's July 14, 1994 Interlocutory Order, the Company submitted the testimony and

[156] It is also important to point out that while the Department allowed an expansive examination of NYNEX's revenue requirement in the course of conducting the earnings review, this uniquely structured review was not what could be considered a traditional revenue requirement investigation, such as that conducted in D.P.U. 86-33-G, or a full rate case -- both of which involve the determination of a specific revenue requirement for purposes of setting rates. The proceeding was not noticed as a full rate case or a revenue requirement investigation, and the stated scope and purpose of the case did not indicate such. See G.L. c. 30A, § 11(1); June 14, 1994 Interlocutory Order ; July 14, 1994 Interlocutory Order . Moreover, the Company's initial filing was structured for a review of its earnings, and the Company has stated that its filing would have been prepared differently if the investigation were a traditional rate case or revenue requirement investigation (see NYNEX Brief at 124, 126). For example, the Company stated that it did not include certain cost of service items in its filing that it would have included in a full rate case or revenue requirement investigation (id.). In addition, while the Department employed customary rate case precedent in this proceeding, it did so not because it viewed this investigation as a rate case, but because those techniques of rate case analysis are a recognized and familiar basis for examining a utility's revenues, expenses, and investment (i.e., rate base). The Department has carefully considered the Attorney General's recommendation to reduce NYNEX's rates in this Order (see Section VII.D.1.a, infra); however, we have found no evidence of overearnings. Even if there were evidence of overearnings, we are not persuaded by the Attorney General that we could order a rate change in this Order, given that this was not a rate case or traditional revenue requirement investigation. Any attempt to change rates in this proceeding would violate (1) NYNEX's due process rights by exceeding the notice, and stated scope and purpose of the case, and (2) the Department's rate-setting authority under G.L. c. 159, § 20.

schedules of John H. Cogswell, a financial consultant, in support of its position that "the Company's currently adjudicated and authorized rate of return is *prima facie* reasonable" (Exh. NYNEX-10, at 3, *citing* *July 14, 1994 Interlocutory Order* at 7). Mr. Cogswell also submitted rebuttal testimony on October 26, 1994. His testimony dealt with the full range of cost-of-capital issues. The Attorney General sponsored the testimony of Timothy Newhard, a financial analyst in the Attorney General's Office, on cost of equity issues.[157]

3. Standard of Review

a. Introduction

Because the parties appear to characterize the Department's earnings review differently, they have presented arguments addressing what standard or standards should be applied.

b. Positions of the Parties

i. Attorney General

The Attorney General claims that NYNEX has provided no legal support for the Company's contentions that (1) this earnings review should be governed by G.L. c. 159, § 17, rather than § 20, and (2) a § 17 proceeding must be a "broad-stroke inquiry" and "less-searching" than a Section 20 review (Attorney General Reply Brief at 14).[158] Moreover, the Attorney General argues that

[157] FEA presented limited information on certain "specific infirmities" of NYNEX's earnings filing (*see* FEA Reply Brief at 8).

(continued...)

rather than setting forth a standard of review, § 17 appears to contain the Filed Rate Doctrine (id. at 14-15). Even if Section 17 applies, the Attorney General contends that the examination of the Company's earnings in this proceeding should be as "intensive" as that conducted by the Department in

[158](...continued)

[158] Section 17 states, inter alia:

> All charges made ... by any common carrier for any service rendered or performed ... shall be just and reasonable ... and every unjust or unreasonable charge is hereby prohibited and declared unlawful; but charges heretofore established and set out in any schedule filed as provided in sections nineteen and nineteen A shall be deemed prima facie lawful until changed or modified by the department ... but this provision shall not give to such rates any greater weight as evidence of the reasonableness of other rates than they would otherwise have.

Section 20 states, inter alia:

> Whenever the department receives notice of any changes proposed to be made in any schedule filed under this chapter which represent a general increase in rates by a common carrier furnishing the service of transmission of intelligence by electricity, it shall notify the attorney general of the same forthwith, and shall thereafter hold a public hearing and make an investigation as to the propriety of such proposed changes .... After such hearing and investigation, the department may make ... such order as would be proper in a proceeding under section fourteen. At any such hearing involving any proposed increase in any rate ... the burden of proof to show that such increase is necessary to obtain a reasonable compensation for the service rendered shall be upon the common carrier. If, at a hearing involving any proposed decrease in any rate ... it shall appear to the department that the said rate ... is insufficient to yield reasonable compensation for the service rendered, the department may determine what will be a just and reasonable minimum to be charged ....

D.P.U. 86-33-G, which, the Attorney General states, also was not a Section 20 general rate case (id. at 15). According to the Attorney General, notwithstanding Section 17's provision that rates are prima facie lawful until changed, Section 17 also dictates that current rates should not be given "any greater weight as evidence of the reasonableness of other rates than they otherwise would have" (id.). Therefore, the Attorney General contends that any arguments about the applicability of Section 14 versus Section 17 versus Section 20 do not matter since the issue is whether the Company's current rates are appropriate to use at the start of the price cap (id.).

ii. NECTA

NECTA contends that the Department's standard of review for judging the reasonableness of NYNEX's rates for the starting point "must be equal to or even greater than that customarily applied in a `standard rate case'" (NECTA Reply Brief at 27). It argues that "[n]o lesser revenue requirements standard should apply here simply because the Company has imprudently mated tariff changes and revenue requirements issues to its request for a wholesale change in the method of rate regulation" (id. at 28).

iii. NYNEX

The Company claims that, as a result of the Department's May 1, 1994 Interlocutory Order, in which the Department declared that the Company's filing was not a petition for a general increase in rates, Section 20 does not govern the Department's earnings review (NYNEX Brief at 125). Section 20, according to the Company, requires the Department to determine whether any proposed increase is necessary to obtain reasonable compensation for the services rendered and to set rates that would yield a "just and reasonable minimum" (id. at 128-129). However, NYNEX argues that this case is controlled by G.L. c. 159, § 17, and, therefore, a different standard must be applied (id. at 129). NYNEX claims that under Section 17, the Department must "assure itself that the Company's rate charges are `just and reasonable'," not necessarily the "minimum" mandated by Section 20 (id.). Under this "less-searching inquiry," NYNEX contends the Department must determine that the Company's rates are not "unjust and unreasonable -- from both the customers' and the Company's perspectives" (id.). However, according to the Company, current rates are "deemed prima facie lawful" and "presumptively reasonable" (id.). NYNEX notes, though, that current rates should not be given "any greater weight as evidence of the reasonableness of other rates than they otherwise would have" (id., citing Section 17).

b. Analysis and Findings

The purpose of the earnings review was to determine whether the Company's current level of earnings indicates that its current rates may reasonably serve as the starting point for price cap regulation. Therefore, the issues that must be addressed are: (1) whether the Company's currently authorized rate of return is reasonable, and if not, what is a reasonable return for NYNEX; and (2) whether the Company's study period expenses, revenues, and rate base produce more than a reasonable return. Based on the Department's findings on these two issues, the Department will determine whether the Company should begin implementing the price cap plan approved in this Order or whether further proceedings are necessary to determine appropriate initial rates. The determination by the Department on the larger issue of the proper rates for the starting point for price cap regulation must be based on the decisions made on the two issues stated above. Thus, the contentions relating to G.L. c. 159, § 17 and § 20 are not precisely on point, and are not controlling of our review. [159]

4. Burden of Proof/Evidentiary Standards

a. Positions of the Parties

i. Attorney General

[159] Because the Attorney General did not define the term "filed rate doctrine," we are unable to address his argument on that point. We are aware of the Federal Energy Commission's ("FERC's") "filed rate doctrine," which "holds that interstate power rates filed with FERC or fixed by FERC must be given binding effect by state utility commissions determining intrastate rates." Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953, 962-967 (1986). However, we fail to see, without further explanation from the Attorney General, how such a doctrine relates to our authority under Section 17.

The Attorney General contends that, even though this proceeding is not being conducted as a "full-scale rate case governed by Section 20," NYNEX has the burden of proving the reasonableness of rates for the starting point under an alternative regulation plan (Attorney General Reply Brief at 7, citing Metropolitan District Comm'n v. Department of Pub. Utils., 352 Mass. 18, 25 (1967); July 14, 1994 Interlocutory Order at 18. In cautioning the Department not to shift the burden of proof to intervenors, he also contends that the Company has the "burden of persuading the Department with record evidence that each challenged test year cost is reasonable" (id. at 8).

The Attorney General disputes the Company's contention that intervenors, "failed to challenge [NYNEX's] prima facie presentation," because they did not present direct cases on certain issues and/or did not conduct cross-examination (id.). According to the Attorney General, while NYNEX is correct that unchallenged test year accounts cannot be arbitrarily excluded from cost of service, "once an expenditure is called into question, the Department must be satisfied that record evidence supports the amount of the expense" (id. at 9, quoting D.P.U. 86-33-G at 74). The Attorney General contends that a party can raise a challenge to an expenditure simply by marking an information response, and that direct testimony or cross-examination is not necessary (id., citing Boston Gas

Company, D.P.U. 93-60-E at 8 (1994); Bay State Gas Company, D.P.U. 92-111, at 5-6 (1992); Eastern Edison Company, D.P.U. 1130, at 51 (1982); New England Tel. and Tel. Co. v. Department of Pub. Utils., 372 Mass. 678, 686 (1977); New England Tel. and Tel. Co. v. Department of Pub. Utils., 376 Mass. 28, 33 (1978)).[160] The Attorney General argues that if an issue is "noticed," the Company must demonstrate with affirmative evidence that a challenged cost is reasonable (id. at 10, citing Deacon Transportation, Inc. v. Department of Pub. Utils., 388 Mass. 390, 394 (1983); Blue Cross of Massachusetts, Inc. v. Commissioner of Insurance, 397 Mass. 117, 122-123 (1986)). Contrary to the Company's claim, the Attorney General maintains that he has rebutted the Company's prima facie showing on the 23 revenue requirement issues with evidence obtained either on cross-examination, through information responses marked as exhibits, or through direct testimony (id. at 11).

ii. NYNEX

NYNEX argues that its burden of proof for the earnings review is different than that for a "standard rate case" (NYNEX Brief at 125). The Company notes that it has the burden of proving the reasonableness of its current level of earnings as an

[160] The Attorney General claims that issues also can be noticed by (1) a previous order, (2) a request for a witness, (3) direct testimony, or (4) cross-examination (Attorney General Reply Brief at 10).

appropriate starting point for the Plan (id. at 126). According to NYNEX, the Department indicated that intervenors could rebut its "prima facie case, either by discrediting Mr. McQuaid or Mr. Cogswell on cross-examination or by presenting experts of [their] own who could prove that the current rates were unreasonable" (id. at 126-127). The Company stated that, with regard to rate of return issues, the Attorney General did present an expert witness, however, for cost of service issues, NYNEX argues that the Attorney General was "mute" and that "[h]is silence has severe consequences" (id. at 127). NYNEX asserts, based on Department precedent, that intervenors must challenge the Company's evidence on expense issues or present their own evidence, otherwise the Company should prevail on those issues (id. at 128, citing D.P.U. 86-33-G at 74 ("unchallenged test year accounts may not arbitrarily be excluded from cost of service ... test year expenses are prima facie evidence of a reasonable level of expenditures")). According to NYNEX, the Company:

> presented evidence as to the test year amounts of all allowable categories of expense, showing that they complied with the standards established in D.P.U. 86-33-G. For his part, the Attorney General conducted cross-examination on ten of the twenty-three contested cost of service issues in his brief. Any fair reading of that cross-examination shows that the Attorney General failed to discredit Mr. McQuaid on any of those ten issues. The Attorney General was silent on the remaining thirteen, and his failure to present an affirmative case is fatal. On the record before it, the Department must find as a matter of law that the Company's current rates are an appropriate starting point for the [Plan] (id.).

With regard to the issue of what is sufficient to satisfy NYNEX's burden of proof, the Company argues that the Attorney General is wrong in suggesting that "[m]erely raising an issue is ... enough to have it removed from cost of service" (NYNEX Reply Brief at 10, citing Boston Edison Company, D.P.U. 19991, at 30 (1979); Lowell Gas Company, D.P.U. 20105, at 30 (1979)). The Company also disputes what it characterizes as the Attorney General's contention that "he may draw whatever inferences he wishes on brief regarding the nature of an expense, without any requirement to support, with even a single morsel of record evidence, any of his inferences, factual conclusions, innuendo, or assertions regarding acceptable accounting conventions" (id. at 11, citing D.P.U. 20105, at 27). According to NYNEX, the Attorney General has "failed to distinguish between `notice', and the need to support one's position by `substantial evidence'" (id. at 11, citing D.P.U. 86-33-G, at 74-76; Bay State Gas Company, D.P.U. 92-111, at 5-6 (1992)). NYNEX argues that "putting the Company on notice" does not overcome the presumption of reasonableness for test year expenses, and any challenge to a test year expense must be based on substantial record evidence (id. at 12, citing D.P.U. 86-33-G at 74-76; D.P.U. 92-111, at 6). The Company maintains that to meet its burden, it can present additional evidence to support the test year expenses in its filing, or "rely on the fact that its books are kept in the normal course of business, are maintained in accordance with FCC accounting rules, and are audited by independent accountants" (id. at 12, citing Exh. NYNEX-9, at 23, 27; Tr. 13, at 90-91). To successfully challenge the Company's showing, NYNEX contends that the Attorney General must present "counter-evidence, or at least some cross-examination" (id.). NYNEX argues that if the Attorney General could successfully challenge an account "by simply asking a question about its gross amount, without identifying any problem on the record," the prima facie evidence rule would be meaningless (id. at 13, citing D.P.U. 86-33-G at 76). Finally, the Company asserts that before the Company is required to "affirmatively demonstrate the reasonableness of each and every" expense item, the Attorney General is required to introduce some evidence of unreasonableness (id. at 13).

b. Analysis and Findings

As noted above, the Department stated early on in this proceeding that NYNEX has the burden of proving the reasonableness of the Company's current level of earnings as an appropriate starting point for the Plan. July 14, 1994 Interlocutory Order at 18.

We agree with NYNEX "that unchallenged test year accounts may not arbitrarily be excluded from cost of service; to this extent, and in this context, the Company's test year expenses constitute what may be styled prima facie evidence of a reasonable level of expenditures." D.P.U. 86-33-G at 74, citing Fitchburg Gas & Elec. Light Co. v. Department of Pub. Utils., 375 Mass. 571, 578 (1978); Fitchburg Gas & Electric Light Company, D.P.U. 1270/1414, at 33 (1983). However, once an expenditure is called into question, the Department must be satisfied that record evidence supports the amount of the expense. D.P.U. 86-33-G at 74, citing Fitchburg, 375 Mass. at 578.[161]

The Department's precedent for calling into question an expenditure (i.e., providing "notice") is well-settled. The Department has held that the obligation to provide notice has been fulfilled where (1) the existence of specific topics for inquiry have been noted in a previous order; (2) a witness has been questioned on a particular topic; (3) an information request has been marked as evidence regarding an issue; or (4) a company has been asked to provide a witness to address a certain topic. Boston Gas Company, D.P.U. 93-60-E at 8 (1994), citing Bay State Gas Company, D.P.U. 92-111, at 6 (1991); NET, D.P.U. 86-33-D at 9 (1987); see also G.L. c. 30A, § 11(1) ("Parties shall have sufficient notice of the issues involved to afford them reasonable opportunity to prepare and present evidence and argument."). We recognize that the notice issue and the standard

[161] Under G.L. c. 30A, the Department's decisions must be based on substantial evidence; that is, such evidence as a reasonable mind might accept as adequate to support a conclusion. G.L. c. 30A, §§ 1(6), 14(7)(e).

applied have arisen in rate cases. Generally, we have applied rate case precedent in our earnings review and, therefore, find that it is reasonable to apply the Department's notice of issues standard in this case. Moreover, neither party has disputed the relevance of this precedent to the instant proceeding.

If a test year expense or issue related to the Company's earnings has been called into question, the Department must determine whether the utility's position or the challenger's position is supported by the record (i.e., whether there is substantial evidence on which the Department may base a conclusion). D.P.U. 92-111, at 6 n.3. For the utility to prevail, it must demonstrate that the amount is reasonable and that the expense meets the Department's standard. See D.P.U. 93-60-E at 8; D.P.U. 86-33-G at 76. If, based on the record as a whole, the Department finds that there is sufficient evidence demonstrating that the amount is unreasonable and/or that it does not meet the Department's standards for reasonableness, then the Company would not prevail on its claim to include the challenged amount. Id.; see also Blue Cross of Massachusetts, Inc. v. Commissioner of Insurance , 397 Mass. 117, 122-123 (1986).

In analyzing the proposed adjustments by intervenors to the Company's cost of service, the Department has applied the above standard. To the extent that it is necessary to address parties' arguments on the question of burden of proof/sufficiency of evidence with respect to individual cost of service items, we do so in our analysis of the intervenors proposed adjustments that follows.

5. NYNEX's Earnings Proposal

NYNEX proposed that its current rates be used as the rates for the starting point for its Plan (Exh. NYNEX-9, at 3). The current rates were found just and reasonable in D.P.U. 93-125, and became effective on April 14, 1994. D.P.U. 93-125.[162]

NYNEX filed testimony and schedules, based on a calendar year 1993 study period,[163] to demonstrate that its current level of earnings is reasonable, and thus that current rates are the appropriate rates for the starting point for its Plan (Exh. NYNEX-9, at 3). The Company first indicated that for the study period, its Return On Investment ("ROI") was 7.83 percent (id. at 4). After making adjustments to reflect both (1) what it considered to be appropriate annualizations and (2) the Department's findings on certain cost of service items in D.P.U. 86-33-G, the Company stated that its ROI for the study period should be 9.82 percent (Exh. NYNEX-9, at 15 & Att. 3). In

[162] As noted earlier, the rates approved in D.P.U. 93-125 were based on a revenue requirement established in D.P.U. 86-33-G in 1989.

[163] The Company has used the term study period in place of the term test year.

its brief, the Company made certain additional adjustments as a result of the hearings and concluded that its ROI for the study period was 7.76 percent, as contrasted with the ROI of 11.24 authorized by the Department in D.P.U. 86-33-G (NYNEX Brief at 123, 126).

The Company stated that instead of seeking a rate increase to address its earnings deficiency, it has proposed its Plan, which NYNEX believes will allow the Company to increase its earnings "while insulating basic exchange ratepayers from the risks of the Company's future business decisions and the uncertainties of changing telecommunications markets" (Exh. NYNEX-9, at 18).

B. Rate Base

1. Introduction

The Company proposed to include in its 1993 cost of service $2,583,089,000 in rate base (Exh. MCI-14). This amount comprises total plant in service of $5,294,509,000, less the reserve for depreciation and amortization of $2,251,498,000, plus cash working capital of $59,063,000, minus the reserve for income taxes and an unamortized pre-1971 income tax credit of $518,986,000 (id.).

2. Fiber

The Company included $157,500,000 in fiber plant in its plant balances (RR-AG-72).

a. Positions of the Parties

i. Attorney General

The Attorney General recommends that the Department disallow a portion of intrastate fiber plant balances, and related to that, intrastate accumulated depreciation, intrastate expenses, intrastate property taxes, and deferred taxes (Attorney General Brief, Part II, at 8-9, citing RR-AG-72).

The Attorney General categorizes the Company's fiber plant into two types of fiber optic cable: (1) that carrying telecommunications service traffic; and (2) that not carrying telecommunications service traffic, including "dark" fiber[164] (id. at 4-5). The Attorney General contends that, although NYNEX distinguishes between fiber carrying traffic and "spare" fiber, spare fiber is the same as dark fiber (id. at 5).

The Attorney General recommends that the Department disallow all the costs of excess and unused fiber, i.e., "spare" fiber and dark fiber, that the Company has not identified as necessary for growth and treat such plant as Account 2002, Property Held for Future Use (Attorney General Reply Brief at 38). According to

[164] The Attorney General defines dark fiber as an unpowered fiber optic line that can provide service after multiplexing equipment is installed on both ends and is tested (Attorney General Brief, Part II, at 4 n.1). The Attorney General's definition of dark fiber is consistent with that of the industry. The term spare fiber has been used in this proceeding to designate fiber that is powered and available but not presently in use.

the Attorney General, the Company currently maintains a certain amount of unused fibers after accounting for growth in its telecommunications system (Attorney General Brief, Part II, at 8).

The Attorney General points out that the prudence of the Company's investment in fiber optic equipment has not been previously litigated, and that the Company's rate base in its last rate case included little or no fiber optic technology (id. at 5, citing D.P.U. 86-33-G). The Attorney General points out that, although the Company claims that dark and spare fiber cables are used to meet customer growth on the system, the Company's own forecasts of growth in customer demand would never require the current levels of excess fiber (id. at 7). Specifically, the Attorney General claims that it will take six years for projected demand growth to overtake the current oversupply situation for interoffice fiber and 15 years for projected demand growth in the local loop to eliminate the current oversupply situation (Attorney General Reply Brief at 38).

Accordingly, the Attorney General recommends that the Department make adjustments to reflect the Company's excess fiber beyond the current and future needs of its intrastate telecommunications customers (id. at 37).

ii. NYNEX

According to the Company, the Attorney General is incorrect in claiming that there is no distinction between spare and dark fiber (NYNEX Brief at 167). NYNEX asserts that spare fiber provides essential standby capacity that is used to meet unpredictable surges in demand and/or to replace defective fiber (id.). In addition, the Company argues that dark fiber provides service to future customers (id. at 168).

Moreover, the Company states that although the issue of dark fiber has not been addressed by the Department, the District of Columbia Public Service Commission ("D.C. Commission") addressed the matter in a 1992 decision where it found that the Chesapeake and Potomac Telephone Company prudently modernized its network, while planning for future needs, and providing route diversity and network survivability (id. at 168-169, citing Chesapeake & Potomac Telephone Co. , Case No. 850 (D.C.P.S.C. 1992), 130 P.U.R. 4th 310, 343-344 (1992)). NYNEX asserts that the D.C. Commission found acceptable a proposed rate base inclusion of extra fiber and that the Department should make similar findings here (id. at 169).

Moreover, the Company asserts that the Department has found previously that transmission investment is "lumpy," like production capacity, and is planned to meet incremental load increases expected to occur beyond a short-term planning horizon (id. at 171, citing Commonwealth Electric Company , D.P.U. 88-135/151, at 183 (1988)). Here, the Company claims that it will grow into its current fiber capacity within six years (id. at 169).

Finally, the Company argues that since (1) fiber contains multiples of 12 strands of fiber, up to 72 strands, and then 144 strands, and (2) the bulk of the cost of installation is in the labor, it is sensible to lay down a sizeable amount of cable and to leave dark the pairs that currently are not being used (id. at 171). Therefore, the Company asserts that its investment in fiber optic cable is both used and useful (id.).

b. Analysis and Findings

The Department includes in a utility's rate base the total investment (less accumulated depreciation) that is prudently incurred, and used and useful in providing service to ratepayers. Western Massachusetts Electric Company , D.P.U. 85-270, at 20-27, 60-66 (1986); Western Massachusetts Electric Company , D.P.U. 84-25, at 33-43 (1984). A prudence review determines whether the Company's investment, based on all it knew or should have known at the time, was reasonable and prudent in light of the circumstances. D.P.U. 85-270, at 21; see Attorney General v. Department of Pub. Utils. , 390 Mass. 208, 229 (1983). In order to be considered "used," the investment must be in service and operating to provide benefits to customers. D.P.U. 85-270, at 60. In order to be considered "useful," the investment must also be needed and economically desirable in providing continuing service to customers. Id. at 63. There are degrees to which plant may be "useful," and the standard allows a continuum of investment recovery and return on investment. For instance, the Department may find only a portion of plant to be "used and useful," so that a utility could recover and earn a return on only that portion of plant. D.P.U. 85-270, at 127-128 (1986). The issue of whether the Company's fiber optic cable is prudent and used and useful has not previously been determined, although fiber has been in use by the Company since 1982 (Exh. AG-445, "General Outside Plant" at 1). The Attorney General argues that a portion of the Company's fiber plant is not used and useful and should be removed from rate base.

The Department allows companies to include anticipated growth in their estimate of the benefits to be realized on the incremental rate base required to serve new customers. Berkshire Gas Company, D.P.U. 92-210, at 23 (1993), citing Colonial Gas Company, D.P.U. 84-94, at 6 (1984). Although pinpointing the appropriate amount of installation of spare fiber for the future is imprecise, we agree with the Company that spare fiber provides standby capability and is needed for future growth. With regard to dark fiber, the record indicates that there is very little dark fiber in proportion to total fiber both interoffice and in the local loop (RR-AG-96 PROPRIETARY); and that the amount is reasonable. Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects the Attorney General's recommendation.

3. Excess Interoffice Cable

As of the end of 1993, the Company's investment in interoffice cable totalled $96,341,112 (RR-NECTA-25).

a. Positions of the Parties

i. Attorney General

The Attorney General contends that ratepayers should not bear the costs of redundant interoffice copper cable facilities where there is ample fiber capacity to provide service (Attorney General Brief, Part II, at 10). Therefore, the Attorney General recommends that the Department remove all the costs, which amount to $84,360,000 in intrastate plant balances and a corresponding amount of intrastate accumulated depreciation, of excess and unused interoffice copper that the Company cannot identify for diverse fiber routing (id.).[165]

According to the Attorney General, the Company indicates that it is currently transferring all interoffice circuits from copper to fiber (id. at 9). The Attorney General maintains that once all circuits are changed from copper, the Company retires the copper, except when it is needed for route diversity (id.,

[165] Diverse fiber routing is the strategy of allocating circuits between two points over more than one geographic location.

citing Exh. AG-89). The Attorney General claims that as of 1990, only 20 percent of interoffice copper was utilized, and that currently only 12 percent of interoffice copper pairs are utilized even though the Company's documents "make the case for the retirement of all interoffice copper cables by 1998" (id. at 9, citing Exhs. AG-239 PROPRIETARY; NECTA-153 PROPRIETARY; Tr. 11, at 94-96).

Therefore, the Attorney General recommends that the Department make adjustments to the Company's excess interoffice copper (Attorney General Reply Brief at 37).

ii. NECTA

NECTA claims excess copper is not used and useful and must be removed from rate base, along with the associated depreciation expense, maintenance expense, and property taxes (NECTA Brief at 88).

NECTA asserts that a 1991 Company document entitled "Business for Retiring Copper Interoffice Cable in 1991" designated 1998 as the end date for use of copper toll cable, and that this information was included in the Company's depreciation study submitted in this proceeding (id. at 87). Moreover, NECTA contends that as of June 1994, NYNEX's interoffice copper pair utilization was only 12.04 percent (id. at 88). NECTA points out that the Department has previously removed plant from rate base that is so minimally used that it is not considered used and useful (NECTA Reply Brief at 32, citing Western Massachusetts Electric Company, D.P.U. 18731 (1975)).

iii. NYNEX

NYNEX contends that the copper cable that is now in use is necessary to provide service to the Company's customers until it is replaced by fiber optic cable (NYNEX Brief at 172). The Company asserts that NECTA's contention that only 12.04 percent of interoffice copper pairs are utilized is incorrect; rather, NYNEX contends that the figure indicates that, on average, 12.04 percent of the copper pairs in each cable that remains in service are being used (id. at 173). NYNEX maintains that the FCC designates a "retirement unit" as the entire cable and not the individual copper pairs in each cable (id., citing 47 C.F.R. § 32.2000(d)(2)(i)). Therefore, according to the Company, each copper cable now in service is "used and useful" and there is no basis for eliminating the cable investment from rate base (id. at 173). In addition, the Company claims that it is accelerating its retirement of copper cable (id.). According to NYNEX, aerial, underground, and buried copper retirements between 1990 and 1992 exceed the retirements achieved between 1987 and 1989, by over $65 million (id.). Further, according to NYNEX, adopting the Attorney General's position would provide utilities with the wrong financial incentives; discouraging utilities from making the optimally "lumpy" investment of new technology to accommodate future demand (NYNEX Reply Brief at 66). Finally, NYNEX argues that because its copper cables have been substantially depreciated, they are not overvalued in rate base (NYNEX Brief at 174). Therefore, according to the Company, the cables are used and useful, and there is no basis for the adjustments proposed by the Attorney General and NECTA (id.).

b. Analysis and Findings

The Department has the authority to review plant previously included in rate base to determine whether it remains used or useful. See, e.g., Fitchburg Gas and Elec. Light Co. v. Department of Pub. Utils., 375 Mass. 571 (1978); Fitchburg Gas and Electric Light Company, D.P.U. 19084 (1977); Fitchburg Gas and Electric Light Company, D.P.U. 18296/18297 (1975). In practice and as a general rule, the Department does not allow the litigation of the used and usefulness of an investment once it has been included in rate base. The Department does not, however, preclude a review of used and usefulness where extraordinary circumstances are found to exist. See Berkshire Gas Company, D.P.U. 92-210-B at 14 (1993). Since copper cable was the first technology introduced to the telephone industry, its investment clearly has been included in the Company's rate base for some time.

Turning to the issue of whether the Company's copper cable remains used and useful, we agree with NYNEX that copper cable is still being used to provide service to customers, and that copper cable has been depreciated by 80 percent [166] (RR-NECTA-25). Finally, we recognize that disallowance of this type of plant may discourage utilities from making the optimal, but necessarily "lumpy," investment of new technology to accommodate future demand. Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects the Attorney General's and NECTA's recommendations.

4. Central Office Space

a. Introduction

The Company booked $541,254,204 to building accounts during 1993 (Exh. AG-475).

b. Positions of the Parties

i. Attorney General

According to the Attorney General, the Company should not be allowed to include in rate base vacant central office space that covers more than an entire floor in any one central office building where the Company is in a position to rent space to outside parties or otherwise use such space (Attorney General Brief, Part II, at 12). The Attorney General calculates this excess amount to be 1.1 percent of the intrastate plant

[166] This is derived by dividing $77,993,959 in depreciation reserve by $96,341,112 in copper plant (RR-NECTA-25).

balances.[167] Therefore, the Attorney General recommends that the Department disallow 1.1 percent of intrastate plant balances, $5.5 million in intrastate accumulated depreciation, $823,000 in intrastate operating expense, 1.1 percent of intrastate property taxes, and 1.1 percent of intrastate deferred taxes associated with the proposed plant balance adjustment (id. at 13).

The Attorney General asserts that for the past several years, NYNEX has replaced analog switches with digital central office switches and that approximately 85 percent of the switches had been converted as of the end of 1993 (id. at 10). According to the Attorney General, these digital switches are much smaller in size than analog switches, taking up about 1/15 the space (id. at 11, citing D.P.U. 86-33-G at 286). The Attorney General maintains that, although the Company has made some effort to reduce this unused space, it is doing so slowly (id.). Accordingly, the Attorney General contends that the Company has an unjustifiably large amount of unused central office space that is extraordinary enough to merit an adjustment by the Department (id. at 11, citing Berkshire Gas Company , D.P.U. 92-210-B at 14 (1993); Attorney General Reply Brief at 40-41).

[167] This is calculated by dividing what the Attorney General characterizes as excess central office space from Lynn, Dorchester, and Lawrence of 67,657 square feet by the Company's total central office space of 6,111,147 square feet (Attorney General Brief, Part II, at 13, citing Exh. AG-784 PROPRIETARY).

ii. NYNEX

Although NYNEX agrees with the Attorney General that digital switches are substantially more compact than analog switches, the Company disagrees with the Attorney General's recommendation to reduce intrastate plant balances by 1.1 percent (NYNEX Brief at 174, 176). First, the Company points out that this issue was raised in its last rate case and that the Department stated,

> We recognize that buildings are not designed so that every square inch of space will be filled with furniture, equipment, and stored items; therefore, there will always be a certain amount of normal vacant floor space in any building. Thus, vacant floor space, in a building that is otherwise used and useful, can be considered excess capacity only if its amount exceeds what is reasonable

(id. at 175, citing D.P.U. 86-33-G at 291). NYNEX points out that in D.P.U. 86-33-G the Department found that the Company made "reasonable efforts to reuse this space where possible" and found it inappropriate to adjust the Company's rate base (id., citing D.P.U. 86-33-G at 291-292).

Second, the Company argues that the Attorney General did not challenge the reasonableness of the vacant space on the record, so the record does not support the Attorney General's proposed adjustment (id. at 175-176). For instance, the Company asserts that the Attorney General took information available at a single point in time and did not investigate whether the Company had plans to reuse the space (id. at 176; NYNEX Reply Brief at 67). According to NYNEX, there is nothing in the record indicating the net book value of the buildings (NYNEX Brief at 176). Moreover, the Company indicates that the FCC designates a "retirement unit" as the complete building, not a single floor (*id.*, *citing* 47 C.F.R. § 32.2000(d)(1) & (2)(i)).

Finally, NYNEX contends that the 1.1 percent amount of vacant space that the Attorney General alleges exists is well within the range of reasonableness and satisfies the standard established in D.P.U. 86-33-G (*id.* at 176).

c. Analysis and Findings

In D.P.U. 86-33-G, the Department allowed for the inclusion of vacant space in rate base if reasonable in amount. D.P.U. 86-33-G at 291-292. The Department finds that circumstances do not warrant revisiting this issue because the evidence in this case indicates that the amount of vacant central office space is reasonable. Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects the Attorney General's recommendation.

5. Materials and Supplies

The Company booked $2,026,253 to Account 1220 Materials and Supplies during 1993 (Exh. NECTA-149). Two subaccounts are at issue: $229,994 booked to subaccount 1220.1910, Equipment Retired In Place; and $103,507 booked to subaccount 1220.2300, Nonregulated Central Office (*id.*).

a. Positions of the Parties

i. NECTA

According to NECTA, the Company's materials and supplies balance includes subaccounts that should be excluded from rate base: (1) equipment retired in place, which amounts to $229,994, because it is not used and useful; and (2) nonregulated central office, which amounts to $103,507, because it is not appropriately charged to telephone ratepayers (NECTA Brief at 78-79).

ii. Attorney General

The Attorney General states that it supports NECTA's position, since this plant is not providing service to ratepayers (Attorney General Reply Brief at 42).

iii. NYNEX

The Company argues that its accounting for equipment retired in place is consistent with FCC Part 32 accounting,[168] which includes both reusable and scrap material in the inventory account (NYNEX Brief at 178, citing 47 C.F.R. §§ 32.1220(f)(1),(2),(4)). According to NYNEX, this material will be reused and should remain in rate base (id. at 179). According to NYNEX, both the Attorney General and NECTA overlook that subaccount 1220.1910 within account 1220 contains equipment that is intended

[168] FCC Part 32 is the section of the FCC regulations that governs the uniform system of accounts for telecommunications companies.

for reuse at other than the original location (NYNEX Reply Brief at 68). The Company's argument regarding item (2) of NECTA's argument is set forth in Section VII.C.15.b, infra, regarding nonregulated services.

b. Analysis and Findings

The Department is not preempted from dictating ratemaking treatment that is different than an accounting standard set out by the FCC. See Louisiana Pub. Serv. Comm'n v. Federal Communications Comm'n, 100 S. Ct. 1890 (1986); see also D.P.U. 86-33-G at 269 n.27. The Department also has previously held that financial standards do not automatically dictate ratemaking treatment. Massachusetts Electric Company, D.P.U. 92-78, at 79-80 (1992). However, we have the discretion to adopt FCC rules for ratemaking purposes. D.P.U. 86-33-G at 275-276. In NET, D.P.U. 411 (1981), the Department allowed the Company to retain in rate base unused station equipment that had been left on customer premises, because it was logical and justifiable for the Company to conclude that such equipment would eventually be reconnected. Id. at 38. In this case, the equipment is intended for reuse and, therefore, the issue is analogous to that addressed in D.P.U. 411. Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects NECTA's and the Attorney General's recommendation.

6. Cash Working Capital

In its day-to-day operations, the Company requires working capital to pay for its O&M expenses. Working capital is provided either through funds internally generated by the Company (i.e., retained earnings) or through short-term borrowing. Department precedent entitles a company to be reimbursed for the costs associated with the use of its own funds and for the interest expense it incurs for borrowing. See Western Massachusetts Electric Company , D.P.U. 87-260, at 22-23 (1988). This reimbursement is accomplished by adding a working capital component to a company's rate base computation.

The Company first developed a cash working capital ("CWC") allowance expense based on the 45-day methodology. The 45-day convention assumes that a period of 45 days elapses between the provision of service and the date of payment for service rendered. Using the 45-day methodology, the Company developed a CWC allowance of $136,152,000 (NYNEX Brief, App. D at 6).

NYNEX also developed a CWC allowance based on a lead-lag study (id.; Exh. MCI-14, at 6). A lead-lag study measures the payment lag (i.e., difference) between O&M expenses and the receipt lag for revenues. Using the lead-lag methodology, the Company originally calculated an expense lag of 37.96 days and a revenue lag of 55.94 days, for a net lag of 17.98 days (RR-AG-61). The 17.98 days multiplied by the Company's total O&M

expense of $1,104,345,000 produces a CWC allowance of $54,400,000 (NYNEX Brief, App. D at 6).

The Company adjusted this amount to reflect a number of adjustments, including: (1) the addition of cash balances; and (2) customer deposits, advances, and unclaimed funds (Exh. MCI-14, at 6). The Company concluded that its overall CWC allowance was $59,063,000 (id.).

a. Positions of the Parties

i. Attorney General

The Attorney General maintains that the Department should reject the Company's attempt to include cash balances as a component to its CWC requirements. According to the Attorney General, if cash balances are included in working capital, the Company would receive compensation from these balances as follows: (1) through the O&M expense portion of the lead-lag study; (2) through the addition of the cash balance to the working capital allowance; and (3) from the interest they receive from the bank on those balances (Attorney General Brief, Part II, at 13-14). The Attorney General also maintains that the Department has previously denied the inclusion of cash balances from rate base and should continue to do so, thereby reducing the Company's CWC allowance by $6,462,927 (id. at 16; Attorney General Reply Brief at 42).

According to the Attorney General, if the Company includes cash balances in its working capital requirements it should use the balance sheet approach (i.e., current assets minus current liabilities) instead of attempting to mix both the balance sheet approach with the lead-lag approach (Attorney General Brief, Part II, at 14-15). As the Attorney General asserts, using the balance sheet approach would result in a CWC requirement of ($120,656,000) (id.).

ii. NYNEX

According to the Company, cash balances were included in its CWC allowance in order to be consistent with the Department's findings in D.P.U. 86-33-G, where cash balances were included as a component of working capital (NYNEX Brief at 177). Therefore, the Company requests that the Department reject the Attorney General's proposal since it is neither consistent with D.P.U. 86-33-G, nor supported by the record (id.).

b. Analysis and Findings

In considering the proper allowance for the Company's CWC needs, the Department shall first address the Attorney General's claim that NYNEX improperly included cash balances in its CWC calculation. The Department had found previously that the cash balances included by the Company in its working capital allowance were not otherwise reflected in its lead-lag study, and thus approved their inclusion in the CWC computation in D.P.U. 86-33-G. However, the Attorney General has correctly stated that the Department's general policy is to exclude cash balances from rate base. Boston Edison Company, D.P.U. 19300, at 7-10 (1978); Fall River Gas Company, D.P.U. 17708, at 5 (1973).

While NYNEX asserts that its cash balances at issue in this case are identical to those at issue in D.P.U. 86-33-G, the Company provided no substantiation of this claim in the lead-lag calculations (Exh. AG-566). Additionally, the Company's explanation of the need for cash balances suggests that its cash needs stem from timing differences which are already accounted for in the lead-lag study (Tr. 12, at 58-61). The Department finds that NYNEX has failed to demonstrate that cash balances have not otherwise been included in the CWC computation. See Commonwealth Electric Company, D.P.U. 89-114/90-331/91-80 Phase I, at 22 (1991). Accordingly, the Department shall exclude NYNEX's cash balances from its working capital allowance.[169]

The Department further finds that NYNEX's working capital allowance also must be revised to reflect the O&M expense level approved in this earnings review. See, e.g., Cambridge Electric Light Company, D.P.U. 92-250, at 244 (1993). The Company's working capital allowance for purposes of this earnings review is

[169] With regard to the Attorney General's proposed use of the balance sheet approach, the Department finds it unnecessary to address the merits of such an approach in this proceeding. See Commonwealth Electric Company, D.P.U. 90-331 (1989).

provided in Schedule 6, below.

C. Expenses

1. NYNEX's Restructuring Costs and Savings

a. NYNEX's Proposal

The Company proposed to adjust its 1993 cost of service for Process Re-engineering ("PRE") initiative costs and work force reduction costs in the amounts of $148,544,000 for 1994, and $34,943,000 for 1995, totalling expenses of $183,487,000 (Exh. NYNEX-9, Att. 5, at 19-20, 24-25). NYNEX also proposed to adjust its cost of service for savings associated with PRE initiatives and One Enterprise (collectively referred to as "PRE initiatives") in the amounts of $25,350,000 for 1994, and $90,375,000 for 1995, totalling savings of $115,725,000 (id. at 17-18, 23).

The Company stated that in February 1993, it announced the beginning of a major effort to identify structural or business process changes that would lower costs, improve customer satisfaction, and enable the Company to react more quickly and effectively to market conditions (Exh. NYNEX-9, at 31). According to NYNEX, the initial set of PRE initiatives involved changes to individual work functions, such as billing, service orders, and budgeting (id. at 31-32). The Company asserted that the major impact of this initiative will be the consolidation of work centers that provide customer service, network provisioning and engineering, and billing functions (id. at 32). The Company indicated that it anticipates a reduction of these work centers from 140 to 20 and a reduction in total employees of 6,200 by end of 1996 (id.). According to the Company, significant cost savings will be realized beginning in 1995 (id.).

NYNEX stated that implementation costs include training and systems enhancements, while work force reduction costs include the anticipated pension, medical and severance costs that will be incurred as a result of employees leaving the payroll in 1994 (id. at 33). According to the Company, for financial accounting purposes, these costs were not considered extraordinary and were reported as costs of continuing operations in accordance with Securities and Exchange Commission ("SEC") requirements (id.). However, the Company pointed out that for regulatory purposes, the FCC allows work force reduction costs to be charged to expense accounts only after such expenses are actually paid (id. at 34).

b. 1996 Savings

i. Positions of the Parties

(A) Attorney General

The Attorney General argues that $39,690,970, associated with 1996 work force reductions savings should be reflected in the cost of service (Attorney General Brief, Part II, at 19). The Attorney General points out that while the Company adjusted its cost of service to reflect those work force reductions that are expected to occur during 1994 and 1995, 1996 work force reductions should also be reflected in the cost of service; otherwise, NYNEX would be including excess employee costs, or waste, and not be providing least cost service (id. at 17-18). The Attorney General argues that the Company has advertised and promoted the PRE initiatives to investors and the public, indicating that the savings are quantifiable (Attorney General Reply Brief at 44). According to the Attorney General, the Company estimates that it will eliminate 100 management and 1570 nonmanagement employees during 1996 (Attorney General Brief, Part II, at 18). The Attorney General calculates the reduction to the 1993 cost of service to be $39,690,970 [170] (id. at 19).

(B) NYNEX

The Company asserts that the telecommunications industry is changing its technology so rapidly that it is impossible to quantify precisely future costs and savings (NYNEX Brief at 181). In addition, the Company asserts that the PRE initiatives are a reasonable and appropriate undertaking in an environment of

[170] The Attorney General calculated this amount by multiplying the 1995 average management wage rate of $76,652 by the 100 management employee reductions, and by multiplying the 1995 average nonmanagement wage rate of $52,700 by the 1570 nonmanagement employee reductions. Each of these products was multiplied by the Massachusetts allocation percentage of 67.36 percent, the intrastate share of 76.68 percent, and the expense portion of 85 percent, and then summed to equal $39,690,970 (Attorney General Brief, Part II, at 19).

rapidly changing technology and an increasingly competitive marketplace and takes issue with the Attorney General's reference to "waste" (id. at 181-182). According to NYNEX, the Attorney General's proposed adjustment violates the Department's standard that the only adjustments allowed for improvements in technology and productivity are those that may reasonably be anticipated between the test year and the first twelve months in which new rates are in effect (id. at 182, citing Commonwealth Electric Company, D.P.U. 89-114/90-331/91-80, Phase One at 160 (1991)).[171] NYNEX contends that even if the amount of savings were not speculative, anything beyond that time would involve constructing a future test year (id., citing Boston Gas Company, D.P.U. 93-60, at 34 (1993); NYNEX Reply Brief at 72). Finally, the Company argues that by 1996 the Company will be operating in accordance with the Plan, if approved, so it would be inappropriate to adjust these rates for events that will occur in 1996 under the Plan (NYNEX Brief at 183). Therefore, the Company claims that the Attorney General's proposed adjustment should be rejected (id.).

ii. Analysis and Findings

The Department previously has stated that improvements in technology and productivity that reasonably may be anticipated

[171] The Company mistakenly referred to D.P.U. 89-114/90-331/91-80 Phase One as a Massachusetts Electric Company case.

between the test year and the first twelve months in which new rates are in effect, and which demonstrate a known and measurable decrease in residual operations and maintenance expense, should be taken into consideration in setting rates. Boston Gas Company, D.P.U. 93-60, at 33-34 (1993); Massachusetts Electric Company, D.P.U. 92-78, at 47-48 (1992); Commonwealth Electric Company, D.P.U. 89-114/90-331/91-80, Phase One at 160 (1991). Thus, pursuant to Department precedent, the Company's 1996 PRE savings associated with work force reductions would not be considered known and measurable or reasonably anticipated. Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects the Attorney General's proposed adjustments.

c. Employee Transfers

i. Positions of the Parties

(A) Attorney General

The Attorney General argues that $37,322,181, associated with employee transfers should be reflected in the cost of service (Attorney General Brief, Part II, at 21). The Attorney General asserts that, although the Company has included in its cost of service the telephone employees who leave NYNEX, it has not included the savings associated with the employees who are reassigned to jobs outside the local exchange telephone business (i.e., reassigned to broadband business) (id. at 20; Attorney

General Reply Brief at 45). Therefore, the Attorney General argues that the Company's cost of service should be reduced by an additional $37,322,181 [172] to reflect the transfer of employees from NYNEX to other businesses (Attorney General Brief, Part II, at 21).

(B) NYNEX

The Company asserts that while some jobs are being eliminated, those affected people are being transferred to other positions elsewhere in the Company's operations (NYNEX Brief at 183-184). NYNEX points out that during cross-examination by the Attorney General, when asked if some employees would be transferred to new business, Mr. McQuaid replied "No, telephony business" (id., citing Tr. 10, at 70; NYNEX Reply Brief at 73). Therefore, NYNEX contends that there is no basis in the record for the Attorney General's proposed adjustment (NYNEX Brief at 184; NYNEX Reply Brief at 73).

ii. Analysis and Findings

The Company has testified that these employees are still being used to provide telephone service (Tr. 10, at 70). The

[172] The Attorney General calculated this amount by multiplying the 1995 average management wage rate of $76,652 by the 427 management employee transfers and the 1995 average nonmanagement wage rate of $52,700 by the 992 nonmanagement employee transfers. Each of these products was multiplied by the Massachusetts allocation of 67.36 percent, the intrastate share of 76.68 percent, and the expense portion of 85 percent, and then summed to equal $37,322,181 (Attorney General Brief, Part II, at 21).

testimonial evidence is credible and, apart from being flatly contradicted on brief, is not counterbalanced by contrary evidence. Therefore, since we find that these employees provide telephone service, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects the Attorney General's proposed adjustment.

d. Overtime Savings

i. Positions of the Parties

(A) Attorney General

The Attorney General argues that $18,005,732, associated with overtime savings related to the work force reductions should be reflected in the cost of service (Attorney General Brief, Part II, at 22). The Attorney General contends that the Company's cost of service should be reduced by the overtime wages paid to those employees whose positions are being eliminated by the PRE initiatives (id. at 22). The Attorney General asserts that although the Company removed from the cost of service straight time (40 hours per week) wages associated with those employees leaving the Company, it failed to take the test-year overtime wages into consideration (id.). According to the Attorney General, since the Company is reducing its work force by 34.85 percent, it should reduce the amount of overtime expense by that percentage times the overtime expense of $51,664,640, or $18,005,732 (id.). The Attorney General notes that this finding should be consistent with the Department's findings on the issue of 1996 PRE initiatives savings and employee transfers (Attorney General Reply Brief at 46).

(B) NYNEX

NYNEX claims that the Attorney General's calculation of overtime wage savings is incorrect, because (1) the Attorney General's 34.85 percent figure includes both 1996 PRE savings and employees being transferred to the Company's telephone service, which makes the figure too large, and (2) the Attorney General assumes that overtime is equally distributed among employees (NYNEX Brief at 184). NYNEX argues that the employees working the most overtime are the most essential to the Company and have increased responsibility and demands as a result of the re-engineering, but that most of the reductions affected the support and clerical staffs who did not work as much overtime as craft personnel (id. at 185; NYNEX Reply Brief at 73). Specifically, the Company claims that during 1993, 89.1 percent of all overtime was associated with craft personnel and 10.9 percent was associated with support personnel (NYNEX Reply Brief at 73-74). According to the Company, this distribution of overtime must be taken into consideration since 80 percent of the departing employees are support personnel (id. at 74, citing Exh. NECTA-107 PROPRIETARY). The Company contends that the resulting overtime for departing employees is de minimis (id.

at 74).

ii. Analysis and Findings

The Company is correct that the Attorney General included both 1996 work force reductions and employee transfers in his adjustment. Since the Department has rejected the Attorney General's adjustments on these two issues, the proper work force reduction percentage is 20.8 percent (4,580 employee reductions during 1994 and 1995/22,005 total employees). Also, the record indicates that support personnel worked less overtime than craft personnel; therefore, overtime should not be applied evenly to all employees. However, contrary to the Company's assertion, the amount of overtime savings is not *de minimis*. Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department finds an adjustment is necessary. A reasonable representation of overtime savings is $2,868,214, thereby decreasing the Company's cost of service by that amount.[173]

e. Vehicles Expense

[173] This amount is derived from the following equation: ($51,664,640 1993 overtime expense * .891 craft personnel overtime * .042 work force reduction) + ($51,664,640 1993 overtime expense * .109 support personnel overtime * .166 work force reduction) = $2,868,214. The work force reduction percentages of 4.2 percent for craft personnel and 16.6 percent for support personnel were calculated by dividing 20 percent of the 4,580 employee reduction over total employees of 22,005, and dividing 80 percent of the 4,580 employee reduction over total employees of 22,005, respectively.

i. Positions of the Parties

(A) Attorney General

The Attorney General argues that $1,813,533, associated with vehicles expense savings should be reflected in the cost of service (Attorney General Reply Brief at 48). The Attorney General maintains that the reduction in the number of employees that the Company will achieve through the PRE initiatives should lead to a proportional reduction in all overhead expenses required to support those employees, such as vehicles expense (Attorney General Brief, Part II, at 22-23). The Attorney General asserts that the Company's cost savings do not provide for vehicle savings; only for the savings associated with salaries, wages, and the related benefits (Attorney General Reply Brief at 47-48). According to the Attorney General, since the Company is seeking a 20 percent reduction [174] in the total number of leased and owned vehicles, its vehicles expense should decrease by that same percentage, multiplied by the test-year vehicles expense of $10,810,000, times the intrastate operations allocation of 76.68 percent, or $1,657,822 (id. at 48).[175] In

[174] The Attorney General originally recommended reducing the vehicles expense by 34.85 percent, but he subsequently revised the figure consistent with the Company's position in its brief (compare Attorney General Brief, Part II, at 23 with Attorney General Reply Brief at 48).

[175] In his reply brief, the Attorney General did not apply the intrastate allocator. Since this figure represents the (continued...)

addition, the Attorney General proposes a reduction to the Company's depreciation expense for its owned vehicles of $155,711 (test-year depreciation expense of $778,557, multiplied by 20 percent)[176] (id.).

(B) NYNEX

NYNEX argues that both the savings associated with the number of employees required to manage and maintain the vehicles and the savings associated with the cost of the vehicles are already reflected in the Company's cost of service (NYNEX Brief at 186, citing Exh. NECTA-107 PROPRIETARY, "Fleet Operations" Section; NYNEX Reply Brief at 74). Therefore, the Company recommends rejecting the Attorney General's adjustment (id.).

ii. Analysis and Findings

Both NYNEX and the Attorney General agree that the Company expects a 20 percent reduction in vehicles expense as a result of downsizing. The dispute is over whether this reduction associated with the cost of the vehicles has already been reflected in the Company's cost of service. Except for the savings associated with the number of employees required to

[175](...continued) combined dollars, the intrastate allocator should be applied (Exh. AG-507).

[176] The Attorney General stated that the depreciation expense is based on the restatement of the Company's depreciation expense using the Company's depreciation accrual rates provided in D.P.U. 86-33-G (Attorney General Reply Brief at 49).

manage and maintain the vehicles, the evidence provided by NYNEX does not adequately support its contention that vehicles expense savings are already reflected in the cost of service (Exh. NECTA-107 PROPRIETARY, "Fleet Operations" Section). Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department finds that an adjustment is necessary, and accepts the Attorney General's proposal to reduce vehicles expense by $1,657,822, and depreciation expense by $155,711.

f. PRE Initiatives Costs

i. Positions of the Parties

(A) Attorney General

The Attorney General asserts that the Company should not be allowed to recover the $183,487,000 in costs associated with the implementation and work force reduction of the PRE initiatives, because ratepayers should not be required to bear the costs of eliminating the Company's past mismanagement and inefficiency (Attorney General Brief, Part II, at 24; Attorney General Reply Brief at 49). The Attorney General maintains that if the Department allows any recovery, only the portion of the PRE initiatives costs that required cash expenditures ($101,530,000 in total) should be allowed (Attorney General Brief, Part II, at 24-25). Furthermore, the Attorney General contends that the amount should be amortized, since it is extraordinary and nonrecurring in nature, and that a seven-year amortization period balances the interests of ratepayers and shareholders (id. at 24-25, 27-28). According to the Attorney General, approximately 80 percent of the work force reduction costs are estimated pension or post-retirement benefits other than pensions ("PBOP") costs, which are book accruals recorded for accounting purposes, but do not represent current cash expenditures to the Company's employees or necessary cash contributions to trust funds (id. at 25-26). The Attorney General maintains that it is unlikely that the Company will make a contribution to the pension and PBOP funds, given the large pension and PBOP surplus situation that exists (Attorney General Reply Brief at 50; citing Boston Gas Company, D.P.U. 93-60, at 214 (1993); Cambridge Electric Light Company, D.P.U. 92-250, at 54 (1993); Massachusetts Electric Company, D.P.U. 92-78, at 83-84 (1992); Western Massachusetts Electric Company, D.P.U. 88-250, at 72-73 (1988); Western Massachusetts Electric Company, D.P.U. 87-260, at 44-47 (1988)). Furthermore, the Attorney General maintains that switching back and forth between accrual and cash accounting is problematic, because it contributes to the possibility of an overrecovery of costs and intergenerational cross-subsidies (id. at 50). Therefore, the Attorney General recommends that, at most, the Company be allowed to recover, through a seven-year amortization, only that portion of the PRE initiatives costs that required cash expenditures [177] (Attorney General Brief, Part II, at 24-28).

(B) NYNEX

The Company maintains that it is not seeking to be compensated for its costs of inefficiency, but for costs it has been required to expend in order to achieve a more efficient operation (NYNEX Brief at 187).

With regard to the Attorney General's criticism of the Company's PRE initiatives costs that did not require a cash expenditure, the Company asserts that although those costs are based on actuarial estimates, they are real and both the FCC and FASB require that those estimates be recognized on the Company's books and that they will be reconciled over time until the actual cash outlays equal the actual booked expense (id. at 188).

With regard to the Attorney General's recommendation to amortize a portion of the PRE initiatives costs over seven years, NYNEX asserts that the FCC's March 24, 1994 Responsible Accounting Officer Letter 24, "Accounting for Work Force Reductions Programs," requires that the PRE initiatives implementation costs be expensed:

> When the restructuring expenses are actually paid or otherwise require Part 32 recognition (for example, adjustment of the transition benefit obligation for the

[177] This proposal would result in a decrease of $168,982,714 ($183,487,000-($101,530,000/7)) to the Company's cost of service.

> reductions under SFAS 106), they will be charged to the appropriate Part 32 expense accounts with a credit to cash or other appropriate accounts

(id. at 190, citing Exh. NYNEX-9, at 34). The Company argues that it incurred hundreds of millions of dollars in costs during 1991, 1992, 1993, and 1994 in order to improve service and lower costs and expects to incur similar costs in 1995 and 1996; thus the PRE initiatives implementation costs are recurring (id. at 191). Therefore, the Company proposes to include in its cost of service the annual expense of $183,487,000 (NYNEX Reply Brief at 76).

ii. Analysis and Findings

The Department has previously found that disallowance of productivity initiative costs gives utilities disincentives to restructure and make improvements. Berkshire Gas Company , D.P.U. 92-210, at 107 (1993). Therefore, the Department rejects the Attorney General's proposal to exclude all PRE initiatives costs from the cost of service.

With regard to the Attorney General's argument that the portion of the PRE initiatives costs that represents pension and PBOP obligations should be excluded from the cost of service, the Department finds that the Company has committed to provide these incentives to its employees if they accept early retirement, so the Company will have to provide those benefits to the former employees over time. Therefore, the Department rejects the

Attorney General's argument.

The Company claims that because it incurred restructuring costs in 1991, has a plan in place for 1994 through 1996, and plans to implement another one in 1997, these expenses are recurring. We disagree. The record evidence does not support a finding that these expenses are annually recurring or even periodically recurring. Fitchburg Gas and Electric Light Company, D.P.U. 1270/1414, at 32 (1983). Department precedent dictates that non-recurring expenses are ineligible for inclusion in the cost of service unless it is demonstrated that they are so extraordinary in nature and amount as to warrant their collection by amortizing them over an appropriate time period. Boston Edison Company, D.P.U. 1720, at 89 (1984); Fitchburg Gas and Electric Light Company, D.P.U. 1270/1414, at 33 (1983). We agree with the Attorney General and find that the PRE expenses for 1994 and 1995 are extraordinary in nature and amount as to warrant their collection by amortizing them. Based on the rapid rate of technological change and the development of competition in the telecommunications industry (see Exh. NYNEX-9, at 28, 41-44), the benefits to ratepayers of the Company's PRE initiatives, and our recognition that not allowing this recovery in cost of service would result in a disincentive for such initiatives, we find that the appropriate amortization period is two years.

The Company's total PRE initiatives costs for 1994 are

$148,544,000 and for 1995 are $183,487,000 for a total of $332,031,000. Therefore, for purposes of determining the reasonableness of the Company's current earnings, the amortization reduces this expense to $166,015,500 ($332,031,000/2), which results in a $17,471,500 decrease to the cost of service ($183,487,000-($332,031,000/2)).

2. Shareholders' Expenses

a. Introduction

As part of its study period O&M expenses, the Company included costs, totalling $860,100, associated with a shareholders' dividend reinvestment plan and the cost of stock transfers (Exh. NECTA-130).

b. Positions of the Parties

i. Attorney General

According to the Attorney General, costs included in NYNEX's 1993 operating and maintenance expenses associated with a shareholders' dividend reinvestment plan and the costs of stock transfers should not be included in the Company's cost of service, because these costs are similar in nature to stock issuance costs and are implicitly included in the determination of the cost of equity (Attorney General Brief, Part II, at 35). The Attorney General maintains that the Department previously has found that the costs of dividend reinvestment plans and stock transfer plans are costs that are recovered through the return on equity (id., citing Western Massachusetts Electric Company, D.P.U. 88-250, at 47 (1989); Western Massachusetts Electric Company, D.P.U. 87-260, at 106-107 (1988)). The Attorney General asserts that the Company has provided no evidence and no new arguments for changing the Department's precedent (id. at 35). Therefore, the Attorney General recommends reducing the Company's cost of service by $860,100 (id. at 36).

ii. NECTA

According to NECTA, $188,462 of costs associated with a 1993 stock split and charged to Massachusetts intrastate operations is non-extraordinary and non-recurring, and should be removed from the cost of service (NECTA Brief at 89). NECTA claims that NYNEX offers no valid reason for including shareholder expenses in the cost of service, nor does the Company address the portion of shareholder expenses that is non-recurring (NECTA Reply Brief at 32).

iii. NYNEX

The Company acknowledges that the Department previously has found that shareholder expenses should not be included in the cost of service but requests that the precedent be reconsidered (NYNEX Brief at 206). According to NYNEX, shareholder expenses are included in the Company's current rates as a result of the decision in D.P.U. 86-33-G, and neither the Company's witness nor the Attorney General's witness suggested that their determinations of the Company's cost of equity included shareholder expenses (id.).

c. Analysis and Findings

The Department's standard with regard to shareholders' expenses is well-settled. Berkshire Gas Company, D.P.U. 92-210, at 52 (1993); Western Massachusetts Electric Company, D.P.U. 88-250, at 47 (1989). The Company fails to justify a deviation from our precedent. Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department accepts the Attorney General's proposed adjustment to reduce the cost of service by $860,100.[178]

3. Travel, Meals, and Entertainment Expenses

a. Introduction

The Company proposed to include in its cost of service $2,576,544 in intrastate costs associated with travel, meals, and entertainment costs exceeding $1000 per expense type (Exhs. AG-509, AG-511 errata; NYNEX Brief App. F).[179] This amount is the total of the following: (1) $1,465,052 in travel, meals, and entertainment expenditures for Headquarters and Equipment Engineering operations, multiplied first by the Company's

[178] We make no findings on NECTA's argument, since the entire expense is inappropriately included in the cost of service.

[179] See Section II.B.4, supra, for a discussion of the Department's procedural ruling allowing NYNEX to include Appendix F in the record.

allocator of 64.132 percent, [180] and then by the intrastate allocator of 76.682 percent; (2) $839,006 in travel, meals, and entertainment expenditures for direct Massachusetts operations, multiplied by the intrastate allocation factor of 76.682 percent; and (3) $1,212,698, which is the Company's allocation of costs for travel, meals, and entertainment from the following affiliates: NYNEX Corporation, NYNEX Science and Technology ("S&T"), NYNEX Government Affairs ("NGA"), and Telesector Resource Group ("TRG") (Exh. AG-511).

b. Positions of the Parties

i. Attorney General

The Attorney General recommends that instead of analyzing every travel, meal, and entertainment expense, the Department should deny the recovery of 50 percent of those costs, because the Company has not met its burden of proof regarding these costs (Attorney General Brief, Part II, at 41). According to the Attorney General, this treatment will ensure that the Company recovers some of its costs while putting it on notice that better tracking of those costs will be required in the future in order to guarantee recovery (id. at 43-44). The Attorney General views this adjustment as conservative and argues that it reduces

[180] The Company used two Massachusetts allocators. The Massachusetts common cost allocator is 64.132 percent, and the Massachusetts indirect cost allocator is 67.36 percent (Exh. AG-623).

administrative burdens by not litigating every expense item (id. at 43-44; Attorney General Reply Brief at 58). The Attorney General contends that the Company identified and itemized $1,702,914 (of which $837,454 is Massachusetts intrastate) in costs that were incurred by NYNEX's headquarters and Equipment Engineering Group and $1,155,469 (of which $886,037 is Massachusetts intrastate) incurred specifically for Massachusetts, and $1,212,698 in affiliated allocations (Attorney General Brief, Part II, at 42-43). Since the total amount in question is $2,936,189, [181] the Attorney General recommends reducing the cost of service by half that amount, or $1,468,095 (id. at 44).

The Attorney General asserts that, although some of the Company's employee-related costs for travel, meals, and entertainment may be legitimate, NYNEX failed to provide satisfactory support for the inclusion of most of these expenses in the cost of service (id. at 40-41, citing Tr. 17, at 29-44). According to the Attorney General, the Company updated its expenses to remove the costs of basketball and baseball tickets, golf course greens fees, and a tennis tournament (id. at 41, citing Exh. AG-511 errata). However, the Attorney General

[181] The Attorney General's figure differs from the Company's proposal, because the Attorney General is referring to original Exhibits AG-509 and AG-511, which have been corrected by the Company.

asserts that the update accounted for only those expenses that the witness could recognize (id.). The Attorney General claims that there are costs that the witness could not identify, such as those associated with Chase Manhattan and Bankers Trust (id. at 41-42). The Attorney General asserts that Department precedent places the burden of proof on the Company to show that its expenses are reasonable (id. at 43, citing Metropolitan District Comm'n v. Department of Pub. Utils., 352 Mass. 18, 24-25 (1967)).

ii. NYNEX

According to NYNEX, the Department previously has rejected similar recommendations by the Attorney General because there was not sufficient evidence in the record to support the denial of specific travel expenses (NYNEX Brief at 210, citing Bay State Gas Company, D.P.U. 92-111, at 152-153 (1992)). The Company maintains that it has rules regarding expenditures on travel, meals, and entertainment and an internal set of checks and balances to provide oversight (id. at 213, citing RR-AG-84). Therefore, according to NYNEX, these expenses have been carefully reviewed and audited along with procedures that will automatically book non-recoverable expenses below-the-line (id. at 213). Moreover, with respect to dollars associated with Chase Manhattan and Bankers Trust, the Company states that these dollars were not paid to the two banks, but were employee expense vouchers processed by the banks in order to reimburse employees[182] (id. at 212; RR-AG-84; Tr. 20, at 64-65). NYNEX points out that it provided a description of the expenses included in its 1993 operating results in response to an Attorney General information request that was marked as Exhibit AG-509 (id. at 212). According to the Company, the exhibit incorrectly listed non-recoverable expenditures such as charities and spousal travel even though those expenditures are charged below-the-line (id.). The Company filed a correction to the exhibit together with an affidavit of Mr. McQuaid explaining that the expenditures that the Attorney General criticizes were never included in 1993 operating results in the first place[183] (id. at 212, App. F). Accordingly, the Company urges the Department to reject the Attorney General's recommendation (id. at 213).

c. Analysis and Findings

There is no evidence suggesting that the Company included any inappropriate travel, meals, or entertainment expenses in its 1993 cost of service. Furthermore, the Attorney General's recommendation to disallow 50 percent of the travel, meals, and entertainment costs is not supported by sufficient evidence in

[182] According to the Company, the processing of employee vouchers was handled by Chase Manhattan for the first half of 1993, and then was transferred to Bankers Trust thereafter (RR-AG-84).

[183] The Department denied the Attorney General's Motion to Strike the affidavit. See Section II.B.4, supra.

the record. The Department has previously rejected similar arguments made by the Attorney General, because he did not provide sufficient evidence to support such a denial. Bay State Gas Company, D.P.U. 92-111, at 154 (1992). Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects the Attorney General's proposal on travel, meals, and entertainment expenses.

4. Tools Expense

a. Introduction

During the test period, the Company booked to expense accounts tools that cost less than $500 and booked to capital accounts tools that cost more than $500. Using this accounting methodology, the Company expensed $3,407,078 for tools during 1993 (Exh. AG-487; RR-AG-66).

b. Positions of the Parties

i. Attorney General

The Attorney General recommends reducing the Company's cost of service by $3,110,662 ($3,407,078 tools expense minus $296,416 depreciation expense[184]) (Attorney General Brief, Part II, at 48). According to the Attorney General, tools and other plant assets that have useful lives greater than one year should be

[184] This is derived by multiplying the 1993 tools expense of $3,407,078 by the 8.7 percent accrual rate for NYNEX's tools account (Attorney General Brief, Part II, at 48; Exhs. AG-441, AG-487; RR-AG-66).

depreciated over their useful lives (id. at 47). The Attorney General argues that NYNEX violated generally accepted accounting principles ("GAAP") by expensing in one year the cost of the tools purchased during the test year (id. at 47-48, citing Accounting Research Bulletin No. 43, c. 9, § C, ¶5). The Attorney General maintains that NYNEX has not obtained approval from the Department for a change in its accounting for tools and has not provided any basis for a change in its accounting methodology (id. at 48). Although the Company cites FCC accounting changes as the reason for the expensing of tools, the Attorney General argues that FCC accounting changes do not and should not control the Department's ratemaking decisions (Attorney General Reply Brief at 60).

ii. NYNEX

The Company argues that its treatment of tools is consistent with the FCC's 1989 accounting rules, which dictate that all tools costing $500 or less be expensed and all tools costing more than $500 be capitalized, and that it has complied with those rules since 1990 (NYNEX Brief at 216-217, citing 4 FCC Rcd 8229 (1989)). NYNEX maintains that during cross-examination by the Attorney General, the Company provided a description of how the Company follows FCC accounting orders and why the rule makes sense (id. at 217). According to the Company, the Accounting Research Bulletin referenced by the Attorney General briefly summarizes capital asset and depreciation accounting without any expert testimony, and therefore it is of little or no value in determining the appropriate accounting treatment (id. at 217-218). Therefore, NYNEX argues that the Attorney General's proposed adjustment should be denied (id. at 218).

c. Analysis and Findings

As we have previously noted, the Department cannot be preempted from dictating different ratemaking treatment from an accounting standard set out by the FCC. See Louisiana Pub. Serv. Comm'n v. Federal Communications Comm'n, 100 S. Ct. 1890 (1986); see also D.P.U. 86-33-G at 269 n.27. The Department has also previously held that financial standards do not automatically dictate ratemaking treatment. Massachusetts Electric Company, D.P.U. 92-78, at 79 (1992). However, we have the discretion to adopt FCC rules for ratemaking purposes. D.P.U. 86-33-G at 275-276. In this instance, the Company's treatment of tools is consistent with the FCC rules with which the Company has complied since 1990 and, more importantly, is reasonable. Therefore, for purposes of determining the reasonableness of the Company's current earnings, we reject the Attorney General's recommendation.

5. Employee Bonuses

a. Introduction

The Company proposed to include in its cost of service

$12,602,891 associated with employee bonuses (Exh. NECTA-204).

b. Positions of the Parties

i. Attorney General

The Attorney General recommends reducing NYNEX's cost of service by $2,147,096 [185] (Attorney General Brief, Part II, at 59). According to the Attorney General, that portion of employee bonuses linked to NYNEX's earnings, return on investment, and stock price is not properly includable in the Company's cost of service (id.). The Attorney General maintains that incentive compensation plans that are based on financial results of a utility only encourage a firm's management to set rates as high as possible, thereby harming ratepayers (id.).

ii. NECTA

According to NECTA, the Company included in its 1993 O&M expenses $12,602,891 in one-time bonuses, incentive payments, and commissions that are not representative of the future, and the entire amount should be removed from the cost of service (NECTA Brief at 96, citing Exh. NECTA-204; Tr. 19, at 165).

iii. NYNEX

According to NYNEX, its bonus plan is consistent with the Department's requirements for recovery of the cost of incentive

[185] This is calculated by multiplying the intrastate share of 76.682 percent by $2,800,000, which is the portion of the employee bonus plan that is linked to NYNEX's earnings, return on investment, and stock price (Attorney General Brief, Part II, at 59 n.37, citing RRs-AG-101, AG-79).

plans, because its bonus plan is reasonable in amount and adequately designed to encourage good employee performance (NYNEX Brief at 228, citing Massachusetts Electric Company, D.P.U. 89-194/195, at 34 (1990)). NYNEX points out that the Department recently approved an executive incentive compensation plan for a utility company where half of an employee's total potential award is tied to the financial performance of the company and half is tied to employee performance (id. at 229, citing Boston Gas Company, D.P.U. 93-60, at 99-100 (1993)). The Company states that its plan is based 75 percent upon improvements in quality of service to customers, reductions in costs, and for some managers, strategic results; the remaining 25 percent is associated with the attainment of earnings objectives (id. at 229-230). NYNEX maintains that employees may receive additional incentive compensation by improving the quality of service to customers and by reducing costs (id. at 230). The Company claims that the Attorney General's argument that incentive plans encourage companies to increase rates is "out of touch with today's competitive, customer-oriented markets" (id. at 229).

Moreover, in response to NECTA's argument, the Company claims that the program is an annually recurring expense that does not vary significantly from year to year (id. at 230-231). Therefore, the Company disagrees with the Attorney General's and

NECTA's proposed adjustments (id.).

c. Analysis and Findings

Incentive compensation plans must be reasonable in amount and designed to attract and retain quality employees. Reasonable amounts for such purposes can be recognized as a cost of service. See, e.g., Boston Gas Co. v. Department of Public Utilities, 405 Mass. 115, 123-124 (1989). The Department previously has allowed the inclusion of such incentive compensation plan expenses in the cost of service. See Boston Gas Company, D.P.U. 93-60, at 99-100 (1993). In Massachusetts Electric Company, D.P.U. 89-194/195 (1989), the Department allowed the recovery of a plan that used New England Electric System's earnings per share as a factor to determine whether an employee would be eligible for a bonus, but the bonus was based on individual performance. In light of our precedent, we find that the Company's plan is reasonably designed to encourage good employee performance and is therefore acceptable.

With regard to NECTA's argument, NECTA has provided no evidence that this bonus is offered only once. While the Company agreed with NECTA that an employee might receive a bonus one year and not the other, that does not mean that the plan would not continue to be offered to employees as a class (whatever the effect on individual members of that class), or that it would vary significantly (Tr. 19, at 165). Therefore, the expense should be characterized as recurring in nature.

The Department finds that the Company's plan is reasonably designed and that the costs associated with the entire plan are recurring in nature. For purposes of determining the reasonableness of the Company's current earnings, the Department rejects the Attorney General's and NECTA's proposed adjustments.

6. TRG Return Requirement and Income Taxes

a. Introduction

Telesector Resources Group ("TRG") charges to NYNEX include a return and an income tax allowance totalling $28,214,436 (Exh. NECTA-194). The return is based on the lowest rate of return on investment allowed in the Company's five-state service area, currently set at 10.6 percent (Exh. AG-579). NECTA has proposed that the return be disallowed in full.

b. Positions of the Parties

i. Attorney General

In response to the Company's argument that FCC treatment of this expense is persuasive, the Attorney General maintains that the FCC's determination to treat certain cost of service items in a particular manner is not controlling on the Department, especially in the areas in which the Department has well established precedent (Attorney General Reply Brief at 36, citing Louisiana Pub. Serv. Comm'n v. Federal Communications Comm'n, 100 S. Ct. 1890 (1986)). The Attorney General again notes that in one instance even NYNEX argues that FCC rulings do not control Department decisions (id.).

ii. NECTA

NECTA argues that because the Company failed to allocate its rate base properly between regulated and nonregulated activities, and had not properly allocated the nonregulated activities of TRG, the TRG return requirement should be removed from the cost of service (NECTA Brief at 94).

NECTA also claims that, although an imputed rate of return is used to calculate the TRG revenue requirement, the income tax calculation uses TRG's virtually all-equity capital structure, with almost no interest deduction, as opposed to synchronizing the interest deduction in the income tax calculation with the capital structure underlying the imputed rate of return (id., citing Tr. 15, at 18-25). NECTA maintains that TRG's income tax allowance would be substantially reduced if interest synchronization were used to determine the income tax allowance (id.). Therefore, in the alternative, NECTA claims that the TRG income tax allowance should be reduced to reflect the interest deduction based upon the 10.6 percent [186] imputed rate of return (id.).

iii. NYNEX

[186] The interest component is 3.78 percent (long term debt of 3.5 percent plus short term debt of .28 percent equals 3.78 percent) (RR-NECTA-26).

NYNEX contends that the charges it incurs from TRG are determined by the United States Telephone Association's ("USTA") Bulletin No. 92-8, which relies on a FCC letter supporting the inclusion of a return on investment for nonregulated affiliates providing services to a regulated entity (NYNEX Brief at 262, citing RR-NECTA-27). The Company contends that its rate of return computation, and the related income tax calculation, were determined in accordance with the USTA/FCC approach (id. at 262-263). The Company maintains that the FCC does not require an allocation of rate base to regulated and nonregulated services (id. at 263). With regard to the income tax allowance, NYNEX notes that, although TRG's rate base is not broken out, all of TRG's charges to NYNEX, including its return, are subject to the FCC's allocation requirements and are ultimately segregated between regulated and nonregulated services (id.).

c. Analysis and Findings

The Department has found that, in order for payments to affiliated companies to qualify for inclusion in rates, the utility must demonstrate that its affiliated charges (1) represent activities specifically beneficial to the utility and not duplicative of work being directly performed by that utility; (2) are at a competitive and reasonable price; and (3) are allocated according to a cost-effective and nondiscriminatory formula. Oxford Water Company , D.P.U. 88-171, at 17 (1989); AT&T, D.P.U. 85-137, at 51-52 (1985); Dedham Water Company, D.P.U. 84-32, at 11 (1984).

NECTA contends that exclusion of a return requirement is justified because the Company has failed to allocate TRG's rate base between regulated and nonregulated activities. Although TRG's rate base is not apportioned between regulated and nonregulated operations, its charges to NYNEX, including the return requirement, are based on an allocation process (Exh. AG-484, TRG Departments and Functions Book (January 1, 1992)). TRG allocates its costs through direct assignment to those affiliates receiving the service (id. at Section II). For those expenses that do not lend themselves to direct assignment, costs are apportioned to the affiliates based on other measures of causality or benefit (id.). Through this process, only those TRG-related expenses attributable to NYNEX are billed to the Company.[187] The Department finds that NECTA has failed to support its contention that NYNEX's TRG expenses are not apportioned between regulated and nonregulated operations.

Furthermore, there is no evidence to support NECTA's argument that TRG's billings to the Company are somehow unnecessary and duplicative of NYNEX's own activities, or that TRG's billings constitute an unreasonable and noncompetitive

[187] In turn, NYNEX allocates its TRG billings between its own regulated and nonregulated activities.

charge to the Company. Accordingly, the Department rejects NECTA's proposed exclusion of a TRG return requirement.

Regarding interest synchronization, the Department has long-standing precedent requiring the use of interest synchronization in the calculation of income tax expense for ratemaking purposes. Boston Edison Company, D.P.U. 906, at 62-65 (1982); Fitchburg Gas and Electric Light Company, D.P.U. 1270/1414, at 46 (1983). Further, in dealing with charges from affiliates, the Department has allowed in rates only the amount that has been computed in a manner similar to that applied to the regulated entity. Massachusetts Electric Company, D.P.U. 92-78, at 84 (1992). Therefore, based on the evidence in this case and for the purpose of determining the reasonableness of the Company's earnings, the Department will decrease the cost of service by $2,600,000, based on a recalculation of the income tax component as computed in Exhibit NECTA-194.

7. TRG Working Capital Component

a. Introduction

In computing its charges to the Company, TRG uses a working capital requirement that is computed pursuant to the standards prescribed by the USTA Bulletin (RR-NECTA-27). The USTA Bulletin specifies that, in the absence of a lead-lag study, nonregulated affiliates should compute their working capital allowances through the "conventional manner;" i.e., current assets less current liabilities, excluding temporary cash investments, investor capital, and the current portion of capital leases (id., FCC letter dated April 20, 1992, at 4).[188] According to NYNEX, the Company's overall lag from receipt of services from its affiliates until payments are rendered is 93.93 days[189] (Tr. 15, at 29). NYNEX stated that while its contractual agreement with TRG does not specify a payment due date for services rendered by TRG, approximately 98 days elapse between the receipt of services from TRG and payment for those services (id. at 29-30). This payment delay, according to the Company, reduces NYNEX's own working capital needs (id. at 30).

b. Positions of the Parties

i. NECTA

NECTA argues that the working capital allowance for TRG should be limited to the 45-day convention used by the Department in the absence of a lead-lag study (NECTA Brief at 95). NECTA asserts that the Department is not bound by the FCC's particular working capital practices and has in the past departed from FCC methods (id.).

ii. NYNEX

[188] This method is commonly known as the "balance sheet" approach.

[189] This corresponds to the expense lag factor for affiliated payments found in the Company's lead-lag study (Exh. AG-566, at 2).

NYNEX contends that its calculation of the working capital component of TRG's rate base complies with the requirements of the USTA Bulletin, which in turn conforms to the requirements laid out by the FCC (NYNEX Brief at 262, citing RR-NECTA-27). Thus, NYNEX concludes that NECTA's concerns about TRG's working capital needs would be more appropriately raised at the FCC and not in this proceeding (id. at 263).

c. Analysis and Findings

While the FCC may have endorsed the use of a balance sheet approach for nonregulated affiliates, the Department is not prohibited by either FCC accounting memoranda or general accounting standards from requiring different treatment for Massachusetts intrastate ratemaking purposes. Massachusetts Electric Company, D.P.U. 92-78, at 79 (1992); Bay State Gas Company, D.P.U. 89-81, at 33 (1989); Western Massachusetts Electric Company, D.P.U. 85-270, at 118-119 (1986); see also Louisiana Pub. Serv. Comm'n v. Federal Communications Comm'n, 100 S. Ct. 1890 (1986). Accordingly, the Department shall evaluate TRG's working capital allowance based on the merits of the record and Department precedent.

The Department has previously found that the balance sheet approach is a poor indicator of a utility's working capital needs. Commonwealth Electric Company, D.P.U. 89-114/90-331/91-80 Phase I, at 21 (1991). However, were the Department to direct the use of NECTA's proposed 45-day lag factor, there would be no significant benefit for NYNEX's customers. While a 45-day factor would reduce the working capital needs of TRG, it would also result in an offsetting increase in the Company's own expense lag, thereby increasing NYNEX's working capital needs and thus negating any benefits associated with the smaller lag factor for TRG. Based on the foregoing, the Department finds that NECTA's argument to substantiate the use of a 45-day lag factor in determining TRG's working capital needs is unpersuasive. Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Department shall not adjust TRG's return requirement associated with working capital.

8. Depreciation Expense

a. Introduction

Traditionally, interstate depreciation rates for telephone companies are represcribed every three years at a FCC-sponsored meeting attended by LECs, the FCC, and affected state public utility commissions. LECs file their proposed depreciation rates, which are then reviewed and commented on by the FCC. Thereafter, a joint meeting is held between the LECs, the FCC, and affected state public utility commissions, at which the state public utility commissions may comment on the LEC's proposed rates. Based on the comments received at these meetings, the LECs formally file revised depreciation rates that are subject to another comment period before the FCC issues its final order.

The Company's current depreciation rates are based on the 1993 represcription meetings. On December 2, 1992, NYNEX filed its 1993 depreciation study with the FCC, seeking a composite accrual rate of 9.9 percent for interstate operations (Exhs. NYNEX-9, at 17; AG-445, Statement A, at 2). On March 8 and 9, 1993, the FCC-sponsored meeting was held, at which representatives of the Company, FCC, Department, and other state public utility commissions with jurisdiction over NYNEX were present[190] (Tr. 10, at 18). Based on the results of this meeting, revised accrual rates were filed by the LECs, including NYNEX, and subject to comment in the summer of 1993 (8 FCC Rcd 5535 (1993)). By order dated January 31, 1994, the FCC approved the revised accrual rates, to take effect January 1, 1993 (9 FCC Rcd 734-735 & App. (1994)). For intrastate Massachusetts purposes, NYNEX had previously adopted the revised accrual rates on July 1, 1993 (Tr. 10, at 18). [191]

b. NYNEX's Proposal

During the test year, the Company booked $368,782,000 to intrastate Massachusetts depreciation expense (Exh. MCI-14,

[190] Representatives of the Attorney General were also in attendance.

[191] The application of the accrual rates authorized by the FCC triennial represcription meetings to the Company's plant mix as of December 31, 1993 result in an accrual rate of 7.61 percent (Exh. AG-445).

at 2). NYNEX proposed to increase its test year depreciation expense by $34,164,000, reflecting (1) a reduction of $443,000 to eliminate depreciation on easements and rights-of-way; and (2) an increase of $34,607,000 attributable to the annualization of the depreciation accrual rates that took effect on July 1, 1993 (Exh. NYNEX-9, Att. 5, at 14; Tr. 10, at 19-20).

NYNEX stated that it will require additional increases in its depreciation rates over the next few years of approximately $100 million (Exh. NYNEX-9, at 17). The Company attributes this to the planned expansion of its broadband network in Massachusetts, and the shorter economic lives of its plant resulting from these technological improvements (id. at 16-18). Starting in late 1995 and into 1996 and 1997, the Company expects to begin increasing its depreciation rates above existing levels, eventually reaching and exceeding the 9.9 percent composite accrual rate originally proposed as part of its 1993 triennial represcription meetings (id. at 17-18, 41-42).

c. Positions of the Parties

i. Attorney General

The Attorney General maintains that NYNEX has failed to support its proposed depreciation expense and accrual rates. The Attorney General argues that, unlike D.P.U. 86-33-G, the Company in this case provided neither a depreciation study nor an expert witness to support its proposed accrual rates (Attorney General

Brief, Part II, at 32). The Attorney General contends that the general understanding of depreciation and its effects on financial statements attested to by the Company's witness do not rise to a showing of expertise in the field of depreciation (Attorney General Reply Brief at 55, citing Tr. 10, at 16-17).

Moreover, the Attorney General argues that NYNEX's reliance on the FCC-approved depreciation accrual rates established in the triennial meetings is misplaced. The Attorney General contends that the Department has repeatedly reserved its right to evaluate the FCC-approved depreciation rates insofar as their applicability to intrastate rate proceedings, and has made changes where deemed appropriate (id. at 54, citing D.P.U. 86-33-G at 268-311). Furthermore, the Attorney General concludes that the Company further distorts the precedential value of the FCC-approved accrual rates by focusing on the composite depreciation accrual rate, instead of the account-by-account evaluation required in D.P.U. 86-33-G (id.).

Accordingly, the Attorney General concludes that NYNEX has failed to support its proposed accrual rates, and that they should be rejected by the Department (Attorney General Brief, Part II, at 32). The Attorney General urges the Department to base the Company's depreciation expense on the accrual rates most recently allowed in D.P.U. 86-33-G (id. at 32-33; Attorney General Reply Brief at 55). As asserted by the Attorney General, based on the accrual rates accepted in D.P.U. 86-33-G, the Company's pro forma depreciation expense would be $345,681,000 (Attorney General Brief, Part II, at 33, citing Exh. AG-443 (errata)). The Attorney General contends that this results in a decrease of $57,265,000 to NYNEX's proposed cost of service (id.).

Consistent with this treatment, the Attorney General advocates that the Company's depreciation reserve and accumulated deferred income tax reserve must be adjusted to remove the effects of the use of a higher, unauthorized accrual rate since D.P.U. 86-33-G was issued (id.). Specifically, the Attorney General proposes that the Company's depreciation reserve be reduced by $4,803,000, and that the accumulated deferred income tax reserve be reduced by $1,864,583 (id., citing Exhs. AG-441, AG-442; Tr. 10, at 22-24; RR-AG-49).

ii. NECTA

NECTA argues that because NYNEX used deficient depreciation rates for purposes of reporting its 1993 operating results, the Company's depreciation expense must be reduced to reflect the intrastate rates approved in D.P.U. 86-33-G (NECTA Brief at 93). NECTA further claims that the Company is not entitled to any change in depreciation rates from those approved in D.P.U. 86-33-G, because NYNEX stated that it is not proposing, as part of this proceeding, to make any change in the accrual rates that were approved in D.P.U. 86-33-G (NECTA Reply Brief at 31-32, citing Tr. 15, at 37-38).

iii. NYNEX

The Company contends that the basic thrust of this investigation is to determine whether NYNEX's existing rates are in basic compliance with the findings made by the Department in D.P.U. 86-33-G (NYNEX Brief at 204). NYNEX argues that, contrary to NECTA's "distortion of the record," the Company began booking its 1993 depreciation rates in July 1993 based on the triennial represcription meetings, and that its current depreciation rates will have to be increased in the future as new technologies come on line and shorten the useful lives of existing plant (NYNEX Reply Brief, at 80-82). NYNEX notes that in D.P.U. 86-33-G, the Department accepted, with several minor exceptions, depreciation accrual rates identical to those approved by the FCC in the Company's 1986/1987 triennial represcription (NYNEX Brief at 204). The Company points out that its most recent composite depreciation accrual rate was determined in March of 1993 as the result of the triennial represcription, which was attended by representatives of the FCC, the Company, and the Department (id. at 202; NYNEX Reply Brief at 80). The Company argues that these FCC-approved rates should be accorded significant evidentiary weight (NYNEX Brief at 204-205). NYNEX notes that the Department has addressed the issue of FCC-based depreciation rates in other cases, and found that the rates prescribed by the FCC must be accorded significant weight (id., citing D.P.U. 86-33-G; AT&T, D.P.U. 85-137, at 72 (1985)).

While NYNEX asserts that the approval of its depreciation accrual rates by the FCC would constitute a sufficient basis on which to approve them, the Company points out that the depreciation study on which the 1993 triennial represcription was based had been submitted early in these proceedings and introduced as an exhibit (id. at 203, citing Exh. AG-445). This study, according to the Company, is extensive in nature and fully complies with the Department's standards regarding the sufficiency of a depreciation study (id. at 203; NYNEX Reply Brief at 82-83).

Moreover, NYNEX disputes the Attorney General's assertion that no expert witness was available for questioning, arguing that it made a witness available for cross-examination who was asked several questions concerning the depreciation study (NYNEX Brief at 203). NYNEX holds that the Attorney General's concern only serves to demonstrate the inadequacy of his arguments (NYNEX Reply Brief at 84). The Company claims that, in what it considers to be a more relevant case on point than those cited by the Attorney General, it is not necessary for a utility to offer a depreciation expert if the accrual rates are based on a FCC represcription order (NYNEX Reply Brief at 83-84, citing AT&T,

D.P.U. 85-178 (1985)).

d. Analysis and Findings

At the outset, the Department finds it necessary to address the Attorney General's and NECTA's arguments against use of the July 1993 depreciation accrual rates. We note that the Department's investigation in this proceeding is intended to determine whether the Company's current earnings provide a reasonable starting point on which to implement its proposed alternative regulation Plan. July 14, 1994 Interlocutory Order at 6-8. As part of this investigation, the Company was entitled to provide whatever information it deemed appropriate to support its contention that current earnings provided a sufficient starting point for its Plan. Given the specific scope of this proceeding, the Department finds that the record here provides a sufficient basis on which to evaluate the Company's earnings, without the need of expert witness testimony on depreciation.[192]

We next address NECTA's contention that NYNEX is not proposing a change from the accrual rates approved in NET, D.P.U. 86-33-G (1989). The record demonstrates that the Company did not intend to seek in this proceeding a rate increase to cover its increased depreciation accrual rates, which took effect

[192] The Department said nothing in D.P.U. 85-137 about a need for a witness, but rather acknowledged the "evidentiary weight" of FCC-prescribed depreciation rates. D.P.U. 85-137, at 72.

on July 1, 1993 (Tr. 15, at 38). Accordingly, the Department finds NECTA's argument on this issue to be without merit.

Regarding the Company's proposed accrual rates, the Department has noted that depreciation studies rely not only on statistical analysis but also on the judgment and expertise of the preparer. The Department has held that where a witness reaches a conclusion about a depreciation study that is at variance with that witness' engineering and statistical analysis, the Department will not accept such a conclusion absent sufficient justification on the record for such a departure. _Cambridge Electric Light Company_ , D.P.U. 92-250, at 64 (1993); _Commonwealth Electric Company_ , D.P.U. 88-135/151, at 37 (1989). While the Department prefers the use of service lives and salvage value estimates based on historical retirement data, we also recognize that where little or no historical retirement data exists or its use is inappropriate, forward-looking estimates of service lives and salvage values may be appropriate. D.P.U. 86-33-G at 281-282. In order for the Department to find that a forecast is reasonable and a reliable basis for setting the accrual rate for that particular account, the underlying assumptions must be supported by substantial evidence. _Id._ at 282-283.

In this proceeding, the Company elected to rely on the results of both its 1993 depreciation study and the FCC represcription meetings as support for its depreciation rates. In AT&T, D.P.U. 85-137, at 72 (1985), the Department found that the depreciation accrual rates established during the represcription process were based on an independent appraisal conducted by a regulatory body, and thus should be accorded evidentiary weight. While the Department recognizes the evidentiary weight of the FCC-prescribed accrual rates, this acceptance does not, as the Company appears to suggest, require automatic acceptance of FCC-prescribed rates for intrastate purposes. The Department has always reserved its right to examine FCC-approved depreciation rates for their applicability to intrastate Massachusetts operations. See D.P.U. 86-33-G, at 281-311; NET-Capital Recovery, D.P.U. 859 (1982).

The Department has examined the Company's depreciation study contained in Exhibit AG-445, both with respect to the supporting calculations and assumptions contained therein, and their relation to the final FCC-approved accrual rates. Our findings are described below.

i. General Accounts

NYNEX has nine accounts that, for purposes of this review, are considered general plant accounts. In the Company's depreciation study, the average remaining lives ("ARLs") and salvage values for eight general plant accounts (Accounts 2112, 2114, 2115, 2116, 2122.1, 2123.1, 2123.2, and 2124) are identical to those accepted by the FCC through the represcription process (Exhs. AG-445, AG-481). The Department has examined the Company's basis for its proposed accrual rates for these accounts and finds that NYNEX has provided sufficient support for its conclusions. Accordingly, the Department accepts the Company's proposed accrual rates for these accounts.

The FCC-approved accrual rate for Account 2121 (Buildings) incorporates a different ARL and salvage value from that originally proposed in the Company's depreciation study. The Department has examined the Company's supporting data for its proposed accrual rate, and evaluated the information in light of the FCC's own findings. The Department finds that the FCC revisions to the ARL and salvage value for this account are consistent with the results of our own analysis. Accordingly, the Department accepts the Company's proposed accrual rate for Account 2121.

ii. Central Office Equipment Accounts

NYNEX has seven central office equipment accounts (Exh. AG-445, General-COE at 1). In the Company's depreciation study, the ARLs and salvage values for four central office equipment accounts (Accounts 2220, 2231, 2232.11, and 2232.2) are identical to those accepted by the FCC through the represcription process (Exhs. AG-445, AG-481). The Department has examined the Company's basis for its proposed accrual rates for these accounts and finds that NYNEX has provided sufficient support for its conclusions. Accordingly, the Department accepts the Company's proposed accrual rates for these accounts.

The FCC-approved accrual rates for Accounts 2211 (Analog Electronic Switches), 2212 (Digital Electronic Switches), and 2232.1 (Circuit Equipment-Digital) incorporate different ARLs and salvage values from those originally proposed in the Company's depreciation study. The Department has examined the Company's supporting data for these proposed accrual rates, and evaluated the information in light of the FCC's own findings. The Department finds that the FCC revisions to the ARLs and salvage values for these accounts are consistent with the results of our own analysis. Accordingly, the Department accepts the Company's proposed accrual rates for accounts 2211, 2212, and 2232.1.

iii. Outside Plant Accounts

NYNEX has 21 outside plant accounts (Exh. AG-445). In the Company's depreciation study, the ARLs and salvage values for seven outside plant accounts (Accounts 2421.21, 2422.21, 2423.21, 2424.11, 2424.21, 2426.11, and 2431) are identical to those accepted by the FCC through the represcription meetings (id.; Exh. AG-481). The Department has examined the Company's basis for its proposed accrual rates for these accounts and finds that NYNEX has provided sufficient support for its conclusions. Accordingly, the Department accepts the Company's proposed accrual rates for these accounts.

The Company proposed the use of a 7.8 percent accrual rate for Account 2422.11 (Underground Cable Exchange Metallic) (Exh. AG-481). In its depreciation study, the Company proposed the use of a gross salvage value of 24 percent and cost of removal of 75 percent for this account (Exh. AG-445, Account 2422.11, at 6). The FCC accepted both the ARL and salvage value proposed for this account (id.; Exh. AG-481). NYNEX excluded from its salvage analysis 1991 data, which it claimed was at an unusually high historic level not likely to be repeated (Exh. AG-445, Account 2422.11, at 6). The Department finds that the Company has failed to substantiate the circumstances that led it to conclude that 1991 data should be excluded from consideration. Accordingly, the Department rejects the use of the proposed accrual rate for Account 2422.11. For purposes of this proceeding, the Department has recalculated the accrual rate for this account and shall apply herein a depreciation accrual rate of 7.7 percent.

With respect to the Company's outside plant accounts other than those addressed above, the Department has examined the Company's supporting data for these proposed accrual rates, and evaluated the information in light of the FCC's own findings. The Department finds that the FCC revisions to the ARLs and salvage values for these accounts are consistent with the results of our own analysis. Accordingly, the Department accepts the Company's proposed accrual rates for those accounts.

iv. Other Accounts

The Company's depreciation study proposed the same ARLs and salvage values for three other accounts (Accounts 2311, 2351, and 2362.7/9) as were accepted by the FCC through the represcription meetings (Exhs. AG-445, AG-481). The Department has examined the Company's basis for its proposed accrual rates for these accounts and finds that NYNEX has provided sufficient support for its conclusions. Accordingly, the Department accepts the Company's proposed accrual rates for these accounts.

v. Application of Results

The purpose of a depreciation study is to develop accrual rates that are then applied to plant balances. The Department finds that it is not inconsistent to apply the accrual rates developed from a plant balance as of a specific date to those plant balances in service on a different date, provided there are no significant changes in plant composition in the intervening period. Cambridge Electric Light Company, D.P.U. 92-250, at 70 (1993). The Department finds that the changes in the composition of NYNEX's depreciable plant between December 31, 1991 and December 31, 1993 do not materially affect the validity of the depreciation study's accrual rates.

Additionally, the Department finds that the Company's elimination of depreciation expense on easements and rights-of-way is consistent with Department precedent. Bay State Gas Company, D.P.U. 92-111, at 122-123 (1992); Western Massachusetts Electric Company, D.P.U. 558, at 28-29 (1981).

vi. Conclusion

In order to calculate the annual depreciation amounts based on the revised accrual rate the Department has determined for Account 2422.11, the Department has removed the difference between the proposed accrual rate of 7.8 percent and the revised 7.7 percent accrual rate, or 0.1 percent, from the Account 2422.11 plant balance as found in Exhibit AG-481. The Department has also removed from cost of service $155,711 in depreciation expense associated with the vehicles discussed in Section VII.C.1.e, supra. Based on the foregoing, the Department finds that the Company's annual depreciation expense is $402,220,317, rather than the $402,946,000 proposed by NYNEX. Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Company's cost of service shall be reduced by $725,663.

9. Corporate Aircraft

a. Introduction

During the test year, NYNEX allocated to Massachusetts intrastate operations $520,091 in aircraft lease expense (RR-AG-57). NYNEX leases a Beechcraft King Air propeller plane which is used by management for short-distance flights within NYNEX's five-state service area (Tr. 12, at 17-19).[193] Under the terms of a triple net lease, the Company is responsible for all costs associated with the plane, including fuel, insurance, and landing fees (id., at 17; RR-AG-56).

b. Positions of Parties

i. Attorney General

The Attorney General argues that NYNEX has inappropriately included in cost of service the expenses for the aircraft. According to the Attorney General, the Company's corporate aircraft is an unreasonable form of business perk for management, and ratepayers should not be compelled to support such an extravagance (Attorney General Brief, Part II, at 46 citing Fall River Gas Company , D.P.U. 750, at 15 (1981); Lowell Gas Company , D.P.U. 18571/18572, at 12-13 (1976); Attorney General Reply Brief at 60).

ii. NYNEX

The Company disputes the Attorney General's characterization of its Beechcraft King as an "extravagance." NYNEX contends that the plane is used by management personnel as a means of travelling around the Company's multistate service area, and

[193] In addition, NYNEX Corporation has two aircraft, a Falcon 50 and Cessna Citation, whose operating costs are charged exclusively to NYNEX Corporation (Exh. AG-585; Tr. 12, at 14-15).

represents a legitimate business expense as compared with the situations presented in the cases cited by the Attorney General (NYNEX Brief at 215-216; NYNEX Reply Brief at 90). The Company argues that under traditional ratemaking, utilities have long been allowed to recover transportation expenses appropriate to the nature of their respective service territories and their legitimate business needs (NYNEX Brief at 216, citing Southern California Edison Company, 42 C.P.U.C. 2d 645 (1991)).

c. Analysis and Findings

In Fall River Gas Company, D.P.U. 750, at 15 (1981), the Department removed the book value of three executive vehicles from rate base because the utility's vehicle selection criteria was found to be excessively directed towards the personal preferences of its officers. In Lowell Gas Company, D.P.U. 18571/18572, at 12-13 (1976), the Department disallowed expenses relative to a yacht personally owned by a company official and putatively used to entertain potential customers.

In the instant case, NYNEX is leasing an aircraft used by Company personnel for Company-related travel. There is no evidence to support the Attorney General's contention that the use of a plane by NYNEX represents either an imprudent transportation decision, or that the plane itself is being used for personal travel. Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the

Department rejects the Attorney General's proposal to remove the Company's aircraft lease expenses from the cost of service.

10. Uncollectible Expense

a. Introduction

During the test year, the Company booked $27,798,566 to its uncollectible expense account (Exh. NYNEX-9, Att. 5, at 8). The Company proposed an adjustment to increase this amount by $3,202,000 (NYNEX Brief, App. D at 9). The $3,202,000 was calculated by taking a three-year average of its uncollectible expense as a percent of total retail revenues, or 1.668 percent, and multiplying this ratio by test year revenues to produce a proposed bad debt expense of $31,001,000 (Tr. 9, at 137-138).

b. Positions of the Parties

i. Attorney General

According to the Attorney General, the Company did not follow Department precedent in calculating its uncollectible expense (Attorney General Brief, Part II, at 48). The Attorney General maintains that Department precedent requires a utility to divide its three-year average of net write-offs by its average total firm sales (i.e., retail revenues) for a corresponding period and to multiply the resulting percentage by the test year normalized firm sales (id. at 49). Therefore, the Attorney General requests that the Department reject the Company's proposed adjustment and require the Company to recalculate its uncollectible expense consistent with Department precedent (id.).

ii. NYNEX

The Company acknowledges on brief that its uncollectible expense was calculated incorrectly and agrees with the Attorney General's calculation (NYNEX Brief at 265).

c. Analysis and Findings

The Department allows utilities to include a representative level of their uncollectible expense in the cost of service for ratemaking purposes. See Western Massachusetts Electric Company, D.P.U. 85-270, at 178 (1986). According to Department precedent, in order for a utility to recover its uncollectible expense, it must first perform a calculation that includes determining the average of the most recent consecutive three-year level of net write-offs, as a percentage of its adjusted test year revenues. Commonwealth Electric Company, D.P.U. 89-114/90-331/91-80, Phase I, at 137-138 (1991). Therefore, since the Company acknowledges on brief that its uncollectible expense was calculated incorrectly, the Department, for purposes of determining the reasonableness of the Company's current earnings, has recalculated the uncollectible expense in accordance with its established precedent. This results in an uncollectible expense ratio of 1.5867 percent, which, when applied to adjusted test year revenues of $1,745,193,000, results in a total uncollectible expense of $27,690,977.

11. Pole Attachments

a. Introduction

NYNEX charges other entities, such as cable television companies, fees for attaching network equipment to its poles. See G.L. c. 166, § 25A; 220 C.M.R. § 45.00. The Company did not provide a separate cost of service item for pole attachments in its filing. However, the Attorney General contends that the Company's pro-forma test year adjustment for this expense should be $4,385,183 (Attorney General Brief, Part II, at 39).

b. Positions of the Parties

i. Attorney General

The Attorney General claims the Company is not charging pole attachment users for the cost of providing the service, and therefore, ratepayers are required to pay for the revenue deficiency caused by pole attachment users (id. at 36-37; Attorney General Reply Brief at 56-57). The Attorney General also maintains that he is not seeking to change the Company's pole attachment rates but seeks to reallocate the cost associated with those rates away from the Company's regulated operations (Attorney General Brief, Part II, at 36; Attorney General Reply Brief at 57).

ii. NECTA

NECTA argues that the Attorney General's recommended pole attachment adjustment be disallowed (NECTA Reply Brief at 39).

NECTA maintains that the Attorney General is rearguing an issue that the Department has already ruled is not within the scope of this investigation (id. at 40). NECTA concludes that unless (1) the Department changes pole attachment rates under G.L. c. 166, § 25A, or (2) NYNEX and its pole attachment licensees agree upon different pole attachment rates, it would be inappropriate for the Department to consider in this case any adjustment to pole attachment revenues and costs (id. at 41).

iii. NYNEX

According to the Company, the Attorney General seeks to reverse the Department's September 19, 1994 Interlocutory Order, by again attempting to make pole attachment cost allocation an issue in this proceeding (NYNEX Brief at 207). In that Order, according to NYNEX, the Department found that in requesting a separate cost of service study for pole attachment rates, the Attorney General had in effect sought to change the allocation of pole attachment costs, and introduce cost allocation into the case (id.). Furthermore, the Company argues that pole attachment rates are regulated under a separate statutory scheme, that prescribes a process for the review of pole attachment rates by the Department (id. at 208, citing G.L. c. 166, § 25A; 220 C.M.R. § 45.00 et seq.). Accordingly, the Company requests that the Department reject the Attorney General's recommendation (id. at 208).

c. Analysis and Findings

In its September 19, 1994 Interlocutory Order, the Department found that in requesting a separate cost of service study for pole attachment rates, the Attorney General had advocated a change in the Department's established method of allocating costs. September 19, 1994 Interlocutory Order at 12. With regard to the Attorney General's recommendations only to reallocate the cost associated with pole attachments away from the Company's regulated operations, the Department finds it inappropriate to reallocate the cost associated with pole attachments without changing the rates themselves. See G.L. c. 166, § 25A; 220 C.M.R. § 45.00 et seq.; September 19, 1994 Interlocutory Order at 12-13, citing July 14, 1994 Interlocutory Order at 7 (cost allocation beyond scope of proceeding). Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department denies the Attorney General's request to reallocate the cost associated with pole attachments.

12. Advertising Expenses

a. Introduction

The following costs are included in the Company's intrastate cost of service:

NYNEX Corporate Image Advertising Charged to NYNEX (Exh. AG-531)	$3,181,000
NYNEX cost for "give-a-way" items	35,000

(Exh. AG-531)	
Subtotal	$3,216,000
NYNEX Corporate Administrative Costs (Exh. AG-701)	549,000
Total Costs	$3,765,000

b. *Positions of the Parties*

i. *Attorney General*

The Attorney General claims that the Department has found that the cost of utility image advertising should not be passed on to ratepayers (Attorney General Brief, Part II, at 44-45, *citing* *NET*, D.P.U. 86-33-G at 82-85 (1989)). The Attorney General argues that the Company has presented no evidence or arguments to support a change in that precedent (*id.* at 45).

The Attorney General maintains that the Company's claim that these advertising costs were permitted in D.P.U. 86-33-G fails to recognize that these costs were not incurred by NYNEX-New England, but were incurred by NYNEX Corporation and allocated to NYNEX-New England (Attorney General Reply Brief at 59). Therefore, the Attorney General claims, this is an affiliate transaction issue (*id.*).

The Attorney General contends that Department precedent holds that:

> [W]hether a charge is directly assigned or generally allocated, a company must demonstrate specifically that ratepayers enjoy a direct benefit from the expenditure of the assigned or allocated funds (*New England*

> Telephone, D.P.U. 86-33-G, p. 134 (1989); American Telephone and Telegraph Company of New England, D.P.U. 85-137, p. 51 (1985)).

(id.).

The Attorney General also contends that the Department held in the last NYNEX rate case that "the reasonableness of advertising expenditures cannot be presumed absolutely, but must be demonstrated on the record" (id. at 59 n.37, citing D.P.U. 86-33-G at 74 (1989)). The Attorney General maintains that NYNEX has not shown any direct benefit to its ratepayers for these allocated expenditures and, therefore, has not met the Department's standard (id. at 60). The Attorney General also argues that, although the Company appears to have removed the direct expenses associated with its institutional advertising, it has not removed the $3,181,000 in NYNEX Corporation image advertising expenses assigned to the Company and $549,000 in indirect administrative costs associated with advertising (Attorney General Brief, Part II, at 45). Therefore, the Attorney General maintains that a total of $3,765,000 in expenses associated with advertising should be removed from the cost of service (id.).

ii. NYNEX

The Company maintains that the Attorney General's reliance on D.P.U. 86-33-G to support his arguments to remove $3,216,000 in image advertising is inappropriate (NYNEX Brief at 214, citing

D.P.U. 86-33-G at 73). NYNEX claims that D.P.U. 86-33-G does not support the Attorney General's position, since in that order the Department relied on the Supreme Judicial Court's holding in New England Tel. and Tel. Co. v. Department of Pub. Utils., 360 Mass. 443 (1971), that a per se rule excluding all image advertising was not acceptable (id.). The Company argues that since there was no challenge in this case to the Department's determination in D.P.U. 86-33-G, the Attorney General's proposed adjustment of $3,216,000 should be rejected (id.).

The Company states that the $549,000 in administrative costs associated with institutional advertising was eliminated from the cost of service by the Company during the evidentiary hearings, in compliance with D.P.U. 86-33-G (id. at 214, citing Tr. 9, at 25).

c. Analysis and Findings

In Boston Gas Company, D.P.U. 88-67, at 113 (1988), the Department stated that companies must demonstrate that "image advertising is non-promotional and directly benefits ratepayers. Failure to do so will result ... in denial of recovery of costs." In Boston Gas Co. v. Department of Pub. Utils., 405 Mass. 115, 119-120 (1989), the Massachusetts Supreme Judicial Court held that the Department can exclude the cost of institutional or image advertising from a utility's cost of service if it finds that the advertising does not directly benefit ratepayers. The decision specifically addressed the ruling in New England Tel. and Tel. Co. v. Department of Pub. Utils., 360 Mass. 443 (1971). While the Supreme Judicial Court's decision primarily was based on a statute that applied only to gas and electric companies, the concerns expressed there regarding the inclusion of image advertising in the cost of service are valid for all types of utilities. The Department finds that based on the evidence in this case and for purposes of determining the reasonableness of the Company's earnings, the Company has not shown that the image advertising that it seeks to include in expenses has benefited ratepayers. Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department disallows $3,216,000 in corporate image advertising expenses.

The $549,000 in advertising administrative costs was removed from the cost of service during evidentiary hearings (Tr. 9, at 25; NYNEX Brief at App. D, Sch. 2). The Department accepts the Company's deletion of $549,000 from the cost of service.

13. Amortization of Software Costs

a. Introduction

The Company's Massachusetts intrastate cost of service includes $22,526,696[194] in Right to Use ("RTU") fees that, for book purposes, were expensed as incurred, and $6,851,000 of

[194] $29,376,771 (RR-AG-79, at 2) X .76682 = $22,526,696 (Attorney General Brief, Part II, at 50-51).

software expenses allocated from TRG[195] (costs that TRG expensed as incurred) (Exh. RR-AG-92).

b. Positions of the Parties

i. Attorney General

The Attorney General maintains that accounting principles require that costs incurred by a company, the benefits of which extend over a number of years, should be allocated over the period of benefit (Attorney General Brief, Part II, at 49-50 (referencing Financial Accounting Standards Board Statement of Concepts No. 6, ¶149, and Accounting Principles Board Opinion 17, ¶28)). The Attorney General argues that the Department has found that "software is an investment that benefits ratepayers for more than one year" (id. at 50, citing Bay State Gas Company, D.P.U. 92-111, at 67-68 (1992)). The Attorney General asserts that the Company has provided no justification for a departure from the Department's precedent (id. at 50).

The Attorney General maintains that simply because the FCC has decided to treat certain cost of service items in a particular manner does not and should not require that the Department handle those items in the same manner, especially in areas in which the Department has well-established precedent (Attorney General Reply Brief at 36, citing Louisiana Pub. Serv.

[195] TRG is a nonregulated affiliate of NYNEX-New England and New York Telephone that provides research and development services to both companies.

Comm'n v. Federal Communications Comm'n , 100 S.Ct. 1890 (1986)). The Attorney General notes that in one instance even NYNEX argues that FCC rulings do not control Department decisions (id. at 36).

The Attorney General argues that the $6,851,000 in allocated TRG software expense should be amortized over five years, thereby reducing the cost of service by $5,480,800, and that the $22,526,696[196] should be amortized over three years[197] (Attorney General Brief, Part II, at 51).

ii. NYNEX

The Company contends that the Attorney General has misapplied generic accounting bulletins and Department precedent (NYNEX Brief at 218). NYNEX maintains that its accounting is prescribed by FCC regulations, which provide that the original cost of initial software for computers will be classified to the same account as the associated hardware (id. at 219, citing 47 C.F.R. § 32.2000(I) (1993)). The Company adds that "subsequent additions or modifications [are to] be expensed to the appropriate expense accounts" (id. at 219, citing In Re

[196] The Attorney General claims that this amount adjusts the booked RTU software expense amount to an amortization based on a three-year period (Attorney General Brief, Part II, at 50). However, the Company's witness testified that this represents the amount that was expensed on the books but, according to tax regulations, should be expensed over three years (Tr. 20, at 57-58).

[197] Three years is the same time period in which these costs are amortized for tax purposes (Exh. RR-AG-79, at 2).

Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies (Parts 31, 33, 42, and 43 of the FCC's Rules), FCC Docket No. 78-196 ¶ 132 (May 15, 1986)).

The Company asserts that its compliance with these FCC rules, capitalizing all initial operating software and expensing all upgrades and changes, also complies with the rule in Bay State Gas Company, D.P.U. 92-111, at 67-68 (1992) (id. at 220). The Company argues that the software costs at issue in Bay State Gas involved a nonrecurring software expenditure and are not comparable to the software costs in this case (NYNEX Reply Brief at 92). NYNEX maintains that the Department has recognized that there is no "correct" accounting for software and has permitted software costs to be expensed where they are recurring expenditures (id. at 93, citing Commonwealth Gas Company, D.P.U. 87-122, at 44-45 (1987)). The Company asserts that the software costs at issue, primarily RTU fees associated with generic upgrades, are regular and constant within all digital switches (id. at 93). The Company contends that the limited extent of the Attorney General's cross-examination on software costs does not constitute a "challenge to the Company's software costs" (NYNEX Brief at 221).

c. Analysis and Findings

While the Attorney General's arguments about amortizing software have some merit, the useful lives of the software are not apparent from the record; therefore, there is not sufficient evidentiary support for the recommended amortization.

The Department has determined that representative levels of expenses that recur on an annual basis are eligible for inclusion in the cost of service. Commonwealth Gas Company, D.P.U. 87-122, at 46 (1987). Based on the evidence in this case and for the purposes of determining the reasonableness of the Company's earnings, the $22,526,696 reflected for 1993 RTU fees is representative of what the Company incurs as an annual expense for this type of cost (RR-AG-79, at 2; Exh. AG-662 PROPRIETARY). The amounts for 1991-1993 fluctuate considerably, but the amount included in the Company's 1993 study period results is approximately equal to the annual average of 1991-1993.

The Department finds that there is no evidence to indicate that similar conditions would not apply to the software costs allocated from TRG. Therefore, the Department finds that, based on the evidence in this case and for the purposes of determining the reasonableness of the Company's earnings, the software costs are reasonable.

14. Costs Associated with Construction Work In Progress and Plant Held for Future Use

a. Introduction

The Company has included $171,779 for property taxes on telephone plant under construction in its cost of service

(Exh. NECTA-211).

b. Positions of the Parties

i. Attorney General

The Attorney General maintains that all costs associated with the Company's construction work in progress and plant held for future use should be removed from the revenue requirement, since this plant is not providing service to the Company's ratepayers (Attorney General Brief, Part II, at 60-61, citing NET, D.P.U. 411, at 17, 19, 29, 30, and 34 (1981)). Thus, the Attorney General argues that the $171,779 in property taxes on telephone plant under construction identified by the Company should be removed (id. at 61).

ii. NECTA

NECTA argues that since plant under construction is excluded from rate base, the associated property taxes must be removed from cost of service (NECTA Brief at 90).

iii. NYNEX

The Company maintains that even though plant under construction is excluded from rate base, operating costs associated with that plant may still be recoverable (NYNEX Brief at 263). The Company cites the example of interest during construction, which is capitalized and added to the book value of plant (id. at 263-264). The Company argues that the property taxes associated with this plant should be allowed as an expense for two reasons: (1) they are an ongoing cost of doing business that would be recognized if capitalized; and (2) the dollar amount is small (id. at 264).

c. Analysis and Findings

The Department's long-standing precedent is to exclude from expenses taxes on property that is not used and useful to the ratepayers. Commonwealth Electric Company , D.P.U. 88-135/151, at 100 (1989); Western Massachusetts Electric Company , D.P.U. 558, at 22-23 (1981). Therefore, based on the evidence in this case and for the purpose of determining the reasonableness of the Company's earnings, the Department will decrease expenses by $171,779.

15. Sufficiently Competitive and Nonregulated Services

a. Sufficiently Competitive Services

i. Introduction

NYNEX provides a number of services that are sufficiently competitive, including Centrex (Exh. NECTA-207). The Company included revenues and expenses associated with these services in its overall earnings calculation (Exhs. NYNEX-9, Att. 2, at 1; MCI-14, at 1, 7).

During the hearings, the Company provided an analysis of its Centrex operations based on revisions to a cost of service study ("COSS") that had been performed on data covering the year ended November 30, 1992 (Exh. NECTA-207). Based on the 1992 study, NYNEX determined that its 1992 operating revenues for Centrex service were $49,770,291, with total pre-income tax expenses of $60,056,952 (id.). Average net Centrex investment for the same period was $87,467,576 (id.). NYNEX updated this analysis by assuming that revenues, expenses, and investment in Centrex grew at the same rate as the growth experienced in Centrex revenue-producing access lines between June 1992 and June 1993, or 7.16 percent (id.). Through extrapolation, NYNEX estimated that its 1993 operating revenues relative to Centrex service were $53,333,844 (id.). Operating expenses other than income taxes were estimated to be $64,357,030, and average net Centrex investment for the same period was estimated as $93,730,254 (id.).

ii. Positions of the Parties

(A) NECTA

NECTA argues that the Company should have removed from its test year operating results the revenue associated with its sufficiently competitive services (NECTA Brief at 93). NECTA reasons that this would be consistent with past Department precedent that holds that sufficiently competitive services should not be subsidized by other services (id.). NECTA notes that the Department clearly placed the Company on notice in NET-Centrex , D.P.U. 85-275/276/277 (1985) that the pricing flexibility accorded to Centrex service meant that any revenue shortfalls from sufficiently competitive services would be absorbed by the Company and not by its customers (NECTA Reply Brief at 33-34, citing NET-Centrex, D.P.U. 85-275/276/277 (1985)). NECTA argues that even though this issue was not raised in D.P.U. 86-33-G, such does not bar its consideration here (id. at 34).

(B) NYNEX

The Company objects to any adjustments for sufficiently competitive services as unnecessary (NYNEX Brief at 231). It contends that the rates established by the Department in NET, D.P.U. 89-300 (1990) did not reflect any costs assigned to sufficiently competitive services, and that the subsequent revenue-neutral transitional filings have continued to maintain this relationship (NYNEX Reply Brief at 109-110).

Additionally, NYNEX notes that in D.P.U. 86-33-G, the Department had not made any adjustments for the Company's sufficiently competitive services, but instead calculated a total revenue requirement for total intrastate Massachusetts operations (NYNEX Brief at 231). In this case, NYNEX maintains that because the issue being considered is the reasonableness of the Company's current level of earnings, there is even less reason to accept NECTA's proposal (id.). The Company argues that NECTA's concern goes more to the issue of cost allocation, which is beyond the scope of this proceeding (id. at 231-232, citing July 14, 1994

Interlocutory Order at 7; NYNEX Reply Brief at 110).

iii. Analysis and Findings

The Department has expressly placed NYNEX on notice that any losses resulting from Centrex will not be imposed on other customer classes. NET, D.P.U. 89-300, at 278 (1990); NET-Centrex, D.P.U. 85-275/276/277 (1985). In NET, D.P.U. 86-33-C (1987), the Department stated its cost allocation policy with respect to sufficiently competitive services. In that Order, the Department found it appropriate for NYNEX to determine the costs for its sufficiently competitive services in the same manner as required for regulated services. Id. at 28.

In D.P.U. 89-300, the Company isolated the revenue requirement for its sufficiently competitive services, thus seeking to ensure that no other class of customer would bear any revenue requirement shortfall for this class. D.P.U. 89-300, at 276. The Company has continued to separate its sufficiently competitive services, including Centrex, in its revenue-neutral transition filings. See NET, D.P.U. 93-125 (1994); NET, D.P.U. 92-100 (1992); NET, D.P.U. 91-30 (1991). The Company's overall reported earnings in this proceeding include Centrex service; NYNEX made no adjustment to its revenues or expenses to reflect the separation of Centrex service (compare Exh. NYNEX-9, Att. 2, at 1 with Exh. MCI-14, at 1, 7).

The Department has previously found that the COSS constitutes an appropriate tool for determining whether a subsidy exists for an unregulated service. D.P.U. 86-33-C at 34 n.6. The Company represented that its 1992 COSS was conducted in accordance with the standards prescribed by the FCC's Cost Allocation Manual. Because the Department is not examining NYNEX's cost allocation methods in this proceeding, the Department finds that the results of the COSS provide a sufficient starting point to evaluate the impact that Centrex service has on the Company's overall operations.

As stated above, NYNEX's Centrex service is operating at a substantial loss. In order to prevent cross-subsidization of this competitive service by ratepayers, the Department can impute sufficient revenues to cover the incremental costs of the nonregulated program, move the program below-the-line with COSS-based allocators, or direct the utility to eliminate the service altogether. Bay State Gas Company, D.P.U. 89-81, at 73 (1989). Based on the record in this case, the Department finds it appropriate to place the Company's Centrex service below-the-line for purposes of this earnings evaluation. In response to the Company's arguments, we note that D.P.U. 89-300 and its subsequent progeny cases were rate structure investigations. Although revenues and expenses of sufficiently competitive services were not included in the development of illustrative tariff rates, the actual rates that resulted from the transitional filings were not equal to the illustrative tariff rates. Therefore, contrary to NYNEX's assertions, the exclusion of sufficiently competitive revenues and expenses in creating the illustrative tariffs cannot be considered adequate to prevent subsidization of those services. Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Company's test year expenses shall be reduced by $64,357,030, and rate base shall be reduced by $93,730,254. The Department shall also make a corresponding reduction to test year revenues of $53,333,844.

b. Nonregulated Services

i. Introduction

NYNEX's nonregulated services consist mostly of inside wire, customer premises equipment ("CPE"), and Voice Messaging Service ("VMS") (Exh. NECTA-136; Tr. 11, at 61-62; Tr. 15, at 31). During the test year, the Company's intrastate operations booked $33,235,614 in nonregulated operations revenues (Exh. AG-486).

In NET-Inside Wire, D.P.U. 86-273, at 1-3 (1986), as a result of actions by the FCC, the Department permitted the Company to provide inside wire service on an optional deregulated basis. As part of its earnings filing in this case, NYNEX removed all expenses, revenues, and investment in inside wire from cost of service (Exh. NYNEX-9, at 14). Accordingly, the Company removed $30,174,000 in revenues, $36,604,000 in expenses, and $3,856,000 in investment relative to inside wire (id. at Att. 5, at 12; Tr. 11, at 66). The Company retained its nonregulated services other than inside wire ("other nonregulated services"), including Network Channel Terminating Equipment ("NCTE")[198] and VMS, in its overall operations (Exh. NECTA-136; Tr. 11, at 76).

During the hearings, the Company provided an analysis of its other nonregulated services based on a COSS covering the year ended November 30, 1992, applying what NYNEX represented to be the methods prescribed by the FCC's Cost Allocation Manual (Exh. AG-484). Based on this analysis, NYNEX determined that its 1993 operating revenues relative to nonregulated services other than inside wire were $3,642,000 (id.). Direct operating expenses other than income taxes were $12,977,719, and average net direct investment for the same period was $15,433,100 (id.). Using this data, the Company adjusted the Cost Allocation Manual-generated operating expenses to account for shared and overhead costs, as well as shared and overhead investment in other nonregulated services (id.). For purposes of the analysis, NYNEX assumed (1) that the relationship of shared and overhead costs to direct costs for other nonregulated services was similar to the relationship between these items for inside wire, and (2)

[198] NCTE provides an interface between customer equipment and Company facilities.

that the relationship between sufficiently allocated investment and direct investment for all customer classes in the COSS is representative of the corresponding relationship for nonregulated services (id.). Based on this analysis, NYNEX estimated that its 1993 operating expenses other than income taxes for other nonregulated services were $17,339,530, and average net investment for the same period was estimated as $19,090,745 (id.).

ii. Positions of Parties

(A) NECTA

NECTA argues that it is inappropriate to include other nonregulated services in the Company's cost of service, particularly NCTE or VMS (NECTA Brief at 78-79; NECTA Reply Brief at 37). Turning first to the issue of NCTE, NECTA contends that nonregulated revenue requirements must be excluded from interstate telephone rates under Part 64 of the FCC's rules (NECTA Brief at 79). Therefore, NECTA advocates that NYNEX be directed to exclude all revenues associated with NCTE, including revenues, maintenance, depreciation, return, taxes, and associated overheads (id.).

Addressing VMS, NECTA argues that as a nonregulated operation, it is inappropriate to include VMS in cost of service (id. at 92). NECTA contends that NYNEX should be directed to identify all VMS revenue requirements, including revenues, maintenance, depreciation, return, taxes, and associated overheads, and remove them from its tariffed cost of service (id.).

According to NECTA, NYNEX has further inflated its test year expenses by failing to remove its operating expenses related to nonregulated services (id. at 90). Because the Company had removed these costs from the COSS filings submitted in the transitional process, NECTA concludes that it would be appropriate to remove these costs from its revenue requirements (id., citing Exh. NECTA-136).

(B) NYNEX

NYNEX maintains that it quantified all revenues, expenses, and investments associated with its nonregulated services as identified under Part 64 of the FCC's rules (NYNEX Brief at 233). The Company notes that the FCC's treatment of nonregulated services does not preempt state regulatory commissions from adopting a different ratemaking approach, including tariffed service, other forms of regulation, or the treatment of operating results above-the-line for intrastate ratemaking purposes (id. at 234). However, NYNEX also contends that the Department has not previously addressed the issue of intrastate ratemaking treatment for nonregulated services, and that NECTA's approach on brief does nothing to assist in the ultimate disposition (id.; NYNEX Reply Brief at 110).

The Company argues that the revenue/cost allocation afforded by Part 64 of the FCC's rules are not dispositive of the question of whether ratepayers are benefited or burdened by the nonregulated services, but would require an evaluation of whether the services provided a contribution above direct costs (NYNEX Brief at 234-235). NYNEX points out that in other cases involving gas utilities, the Department has treated unregulated operations differently on a case-by-case basis (NYNEX Reply Brief at 110, citing Commonwealth Gas Company, D.P.U. 87-122, at 20-21 (1987) (appliance rentals included above-the-line); Essex County Gas Company, D.P.U. 87-59, at 11 (1987) (appliance rentals included above-the-line); Bay State Gas Company, D.P.U. 777 (1982) (appliance sales placed below-the-line)). NYNEX contends that since NECTA failed to provide any analysis to support either above- or below-the-line accounting treatment, no adjustment to the cost of service is necessary (NYNEX Brief at 234; NYNEX Reply Brief at 111).

iii. Analysis and Findings

The Department has previously found that the COSS constitutes an appropriate tool for determining whether a subsidy exists for an unregulated service. NET, D.P.U. 86-33-C at 34 n.6 (1987). While NYNEX has isolated its inside wire revenue requirement from those of other nonregulated services and placed inside wire revenue requirements below the line, the Company's overall reported earnings in this proceeding include revenues from other nonregulated services; NYNEX made no adjustment to its revenues or expenses to reflect the separation of its other nonregulated operations (compare Exh. NYNEX-9, Att. 2, at 1 with Exh. MCI-14, at 5).

The Company represented that its 1992 COSS was conducted in accordance with the standards prescribed by the FCC's Cost Allocation Manual. Because the Department is not examining NYNEX's cost allocation methods in this proceeding, the Department finds that the use of the Cost Allocation Manual to derive the COSS provides a sufficient starting point to evaluate the impact of other nonregulated services on the Company's overall operations. The Department also finds, for purposes of this proceeding, that the use of the results of the 1992 COSS for inside wire represents an equitable means to apportion the Company's shared and overhead costs between regulated and other nonregulated operations.

As stated above, NYNEX's other nonregulated services are operating at a substantial loss. In order to prevent cross-subsidization of nonregulated utility operations by regulated customers, the Department can impute sufficient revenues to cover the incremental costs of the nonregulated program, move the program below-the-line with COSS-based allocators, or direct the utility to eliminate the service altogether. Bay State Gas Company, D.P.U. 89-81, at 73 (1989). Based on the record in this case, the Department finds it appropriate to place the Company's other nonregulated services below-the-line for purposes of this earnings evaluation. Accordingly, the Company's test year expenses shall be reduced by $17,339,530, and rate base shall be reduced by $19,090,745. The Department shall also make a corresponding reduction to test year revenues of $3,642,000.

16. Affiliated Transactions

a. Introduction

NYNEX Corporation, a publicly-held corporation, is one of seven regional holding companies created as a result of the divesture of AT&T on January 1, 1984. The Company and New York Telephone ("NYT") are two of ten principal subsidiaries of NYNEX Corporation. Most of NYNEX Corporation's other subsidiaries provide communications-related products or services, or support the provision of such by other NYNEX Corporation operations. During the test year, a total of $256,234,000 in affiliated transactions was allocated to the Company's intrastate operations (Exh. AG-484), as further described below.

NYNEX Corporation performs corporate governance and ownership functions, including external financing, preparation of tax returns, SEC matters, shareholder relations, corporate legal responsibilities, and other management functions (Exh. NYNEX-9, at 21-22). During the test year, $25,456,000 in expenses relative to NYNEX Corporation were allocated to the Company's intrastate operations (Exh. AG-484).

TRG was formed in 1990 as a result of the transfer of NYNEX Material Enterprises Company from NYNEX Corporation to NYNEX-New England and NYT (Exh. AG-460, 1993 10-K at 5). TRG operates and maintains major data processing hardware and systems, provides staff and operational support, and material management services to the NYNEX companies (Exhs. NYNEX-9, at 19-20; AG-484, Cost Allocation Manual at V-7)). During the test year, $224,501,000 in expenses relative to TRG were allocated to the Company's intrastate operations (Exh. AG-484).

NYNEX S&T is responsible for NYNEX Corporation-wide research and development, with a primary focus on supporting the introduction of new technologies and performing technical planning and related network standards functions for NYNEX-New England and NYT (Exhs. NYNEX-9, at 20; AG-484, Cost Allocation Manual at V-26). The functions here include Broadband Data and Switch Platform, Broadband/Video System Engineering, Multimedia and Information Services, Wireless and Cellular Platforms, and Network Operating Technology. Most of these expenses are incurred by TRG, which in turn passes on these charges to the Company and NYT as part of TRG's own billings (Exh. AG-596). During the test year, $1,740,000 in S&T charges were allocated to the Company's intrastate operations (Exh. AG-484).[199]

Bellcore is a centralized services organization that was established with the divesture of AT&T in order to provide technical support to the RHCs in the areas of exchange and access services (Exh. NYNEX-9, at 20). NYNEX Corporation's investment in Bellcore is held by TRG (Exh. AG-673). Bellcore bills TRG for NYNEX Corporation's share of those Bellcore projects in which it participates, and in turn TRG apportions these costs between the Company, NYT, and other NYNEX affiliates (Exh. AG-484, Cost Allocation Manual at V-10). During the test year, $17,589,000 in Bellcore expenses were allocated to the Company's intrastate operations, including $6,630,317 in research and development costs (Exhs. AG-484; AG-596, at 5).

NGA is responsible for legislative contacts and lobbying with the FCC, other federal agencies and departments, as well as the executive and legislative branches of the federal government (Exh. NYNEX-9, at 21). During the test year, $505,000 in expenses relative to NGA were allocated to the Company's Massachusetts operations (Exh. AG-484). According to the Company, since 1991, all expenses relative to lobbying activities, including those of NGA, have been booked to

[199] An additional $8,050,200 in TRG billings to NYNEX for various S&T projects then was allocated to intrastate Massachusetts operations (Exh. AG-596, at 1-2).

non-operating expense accounts and are thus considered below-the-line for ratemaking purposes (Exhs. NYNEX-9, at 13-14, 21; AG-677).

NYNEX Information Resources Company ("NIRC") provides directory publishing services, database management and delivery services, and information technology services to NYNEX-New England and NYT through directory licensing and associated agreements (Exh. NYNEX-9, at 21). During the test year, $2,921,000 in expenses relative to NIRC were allocated to the Company's intrastate operations (Exh. AG-484).

NYNEX Properties ("NP") manages certain real estate for NYNEX (id.). While NP is being phased out, and no longer provides services to NYT, it continues to lease space for NYNEX-New England (id., Cost Allocation Manual at V-16). During the test year, $1,024,000 in expenses relative to NP were allocated to the Company's intrastate operations (Exh. AG-484).

In D.P.U. 86-33-G, the Department expressed concern over some unresolved issues related to the Company's relationship with its holding company and affiliates. D.P.U. 86-33-G at 140. Finding that an independent audit of NYNEX's affiliated transactions was necessary to further examine these issues outside the context of a litigated proceeding, the Department directed the Company to engage in an independent, objective and comprehensive audit of its management and operations. Id.

at 141-142. Pursuant to this directive, NYNEX underwent a comprehensive audit of its operations in accordance with the Department's requirements (Exhs. AG-465, Part 3; NYNEX-9, at 22). The audit, performed by Schumaker & Company, was completed in January of 1991 and offered 43 recommendations to improve the Company's operations (Exh. AG-465, Part 3, at 1). Most of the recommendations were accepted by NYNEX and ultimately implemented by September of 1992 (Exh. NYNEX-9, at 23-24).

NYNEX has been upgrading its existing network to provide numerous broadband services (Exh. NECTA-168).[200] While the Company has incurred expenses relative to the construction of broadband facilities intended for video services, it stated that it has not purchased to date any equipment intended for the exclusive use of video (id.). In addition to its broadband expenditures, NYNEX has incurred some expenses in connection with research on video dial-tone service and equipment, including network planning and preliminary work in connection with its video dial-tone application (id.).

The FCC does not require separate accounting for the broadband deployment or video dial-tone commercial service costs (id.). While NYNEX has developed an internal tracking mechanism

[200] Broadband is generally defined as any transmission over 1.5 megabits-per-second, which would be sufficient to carry video programming (Exh. NECTA-196, Impact, Summer 1993, at 22).

to track these expenditures through the use of special subsidiary accounting records, it has not otherwise provided for separate accounting treatment (id.; Exh. NECTA-111).

S&T's Wireless Communications lab is involved in a number of projects that benefit both telephone companies, NYNEX Mobile Communications, and other nonregulated affiliates (Exh. NECTA-218). According to the Company, approximately 70 percent of the Wireless Communications lab's costs are related either to NYNEX Mobile Communications or to NYNEX Corporation for exploratory development, and billed to these entities (id.). During the test year, $408,000 in Wireless Communications lab expenditures were booked to Massachusetts intrastate operations (id.).

i. Positions of Parties

(A) Attorney General

The Attorney General identifies some $3,540,800 in expenses related to TRG's video, broadband and multimedia activities that, he claims, do not relate to the provision of local exchange service (Attorney General Brief, Part II, at 39-40). Specifically, the Attorney General argues that $1,852,000 in TRG broadband activities, $183,000 in TRG video dial-tone, $513,000 in TRG video trial, $336,511 in TRG multimedia trial, and $656,289 relative to VMS should be excluded from cost of service (id., citing Exhs. NECTA-182; NECTA-181; NECTA-170; NECTA-111;

NECTA-191; and NECTA-154). [201] He also contends that another $408,000 in S&T wireless communications expenses and $2,686,000 related to S&T broadband development costs are not related to local exchange service (id. at 40, citing Exhs. NECTA-218; NECTA-227). Therefore, the Attorney General concludes that NYNEX's cost of service should be reduced by $6,635,000 (Attorney General Reply Brief at 69).

The Attorney General asserts that NYNEX's video and broadband research and development ("R&D") activities are intended to allow it to deploy a cable television system at the expense of telephone customers (id. at 68). In response to the Company's argument that he had not demonstrated on the record that NYNEX's video and broadband R&D expenses were associated with cable television, the Attorney General responds that the issues were properly raised during hearings, and that the Company is unfairly attempting to shift the burden of proof (id. at 67). The Attorney General compares the magnitude of the Company's ongoing activities to what he considers the basic R&D expenses at issue in D.P.U. 86-33-G, concluding that the existing R&D expenses should be deferred and charged to future users of the service (id. at 68).

[201] The Attorney General's citations on brief to Exhibits NECTA-182 and NECTA-181 should be to Exhibits NECTA-181 and NECTA-180, respectively. See Attorney General Reply Brief at 69 n.40.

(B) NECTA

According to NECTA, the Company's test year expenses concerning affiliate transactions are rife with costs relative to video transport, video-on-demand ("VOD"), and broadband applications that should be excluded from cost of service (NECTA Brief at 75; NECTA Reply Brief at 17-18). NECTA maintains that NYNEX's cost of service should be reduced by at least $18,629,482 (NECTA Brief at 75-92).

In its reply brief, NECTA addresses several of the Company's arguments in favor of including these expenses in cost of service. First, NECTA argues that the FCC still maintains jurisdiction over broadcast entertainment, and that the FCC's decision in Memorandum Opinion and Order, CC Docket No. 87-266 (November 7, 1994) leaves the issue of state jurisdiction over video-related services limited (NECTA Reply Brief at 20). NECTA faults NYNEX for not supplementing any of its responses to information or record requests to reflect the FCC's recent ruling concerning federal and state jurisdiction over video dial-tone (id. at 18). Furthermore, NECTA claims that the possibility of intrastate video regulation makes it all the more appropriate to defer NYNEX's video-related R&D expenses (id. at 19).

Second, NECTA argues that the Company has improperly attempted to shift to the intervenors the burden of proof that its video-related charges from affiliates are reasonable (id.

at 21). According to NECTA, the Massachusetts legislature has placed upon the Company the responsibility of proving the propriety of its affiliated transactions (id. at 21, citing G.L. c. 159, § 34A(e)).

Third, NECTA contends that deferral or disallowance of NYNEX's Bellcore video expenses is warranted. NECTA contends that other states that have disallowed or deferred Bellcore R&D expenses have rejected arguments identical to those being proposed by the Company in this proceeding (id. at 22, citing Illinois Bell Company , 156 PUR 4th 121, 209 (1994)). NECTA distinguishes its proposed treatment from the Department's decision in D.P.U. 86-33-G regarding Bellcore's 800 Service R&D expenses, noting that future broadband video platform rate treatment is uncertain at this time (id. at 22).

Fourth, NECTA rejects the Company's accounting arguments as irrelevant to NECTA's allegations that video-related affiliate transactions relate to future service (id. at 23). According to NECTA, NYNEX has failed to quantify what portion of video-related transactions, if any, provides current benefits to Massachusetts customers (id.).

Fifth, NECTA contends that a "simple" reading of NYNEX's broad plans and project descriptions clearly demonstrates that expenses charged to NYNEX by its affiliates do not belong presently in the Company's intrastate telephone revenue requirement (id. at 24). NECTA maintains that NYNEX's recitation of technical broadband descriptions are immaterial to the issue of charging current ratepayers for the specific affiliate transactions (id.).

NECTA identifies on brief expenses relative to TRG and S&T that it contends should be excluded from cost of service. These are enumerated below.

According to NECTA, $554,000 in test year charges from TRG associated with S&T's Transmission and Video Systems relate to new transport technologies and VOD service and should be removed from cost of service (NECTA Brief at 75, citing Exh. NECTA-182; Tr. 15, at 32). NECTA reasons that because future VOD services will be interstate, these charges provide no benefit to intrastate ratepayers (id.). In the alternative, NECTA suggests that these expenses be deferred until such time that NYNEX offers VOD services, at which time the trial costs can be directly assigned to VOD customers (id.).

Turning to the issue of payments to TRG and S&T relative to broadband prototype applications and services, NECTA states that almost all, if not the entire, $636,000 associated with this activity are associated with video and video transport services (id. at 75-76, citing Exh. NECTA-181). Claiming that this would represent an interstate service, NECTA advocates that these expenses be removed from cost of service (id. at 76).

NECTA contends that $183,100 in payments to TRG are relative to video transport or video dial-tone service research involving compressed video using twisted pair cable, instead of broadband, technology (id. at 76, citing Exh. NECTA-170). NECTA argues that these expenses are associated with nonregulated or interstate operations, and should be removed from cost of service (id.). NECTA further argues that this treatment is consistent with the Company's agreed-to removal of its New York video dial-tone trial expenses from cost of service (NECTA Reply Brief at 39). In the alternative, NECTA contends that because NYNEX ended its "planning effort" with respect to this technology in early 1994, these expenses represent nonrecurring costs that should be removed from cost of service (NECTA Brief at 76, citing Exh. NECTA-170; NECTA Reply Brief at 39).

NECTA argues that $513,000 in TRG charges relating to a 1993 video dial-tone trial in New York is unrelated to Massachusetts intrastate operations, and thus should not be included in cost of service (id., citing Exhs. NECTA-111; NECTA-173). NECTA notes that the Company conceded during hearings that the expense should be removed from cost of service (NECTA Brief at 76, citing Tr. 11, at 42). NECTA also expresses concern over what it alleges is the Company's failure to require detailed time records from TRG employees engaged in video dial-tone trial activities (NECTA Brief at 76-77).

According to NECTA, S&T directly billed $1,740,000 to NYNEX's intrastate operations for various research projects, with an additional $8,050,200 billed by TRG on behalf of various S&T projects (id. at 77, citing Exh. NECTA-128, at 2; RR-NECTA-24). NECTA argues that a significant portion of these costs should not be charged to intrastate operations, and must be removed from cost of service in order to prevent the cross-subsidization of NYNEX's future nonregulated and video services (id.). Specifically, NECTA identifies nine projects listed in Exhibit NECTA-128, totalling $4,870,200, which it contends should be removed from cost of service (id., citing Exh. NECTA-128; RR-NECTA-24).

NECTA also takes issue with the Company's allocation of S&T overheads. NECTA argues that the Company has failed to directly allocate $3,950,000 associated with S&T overheads between its regulated and nonregulated service projects, in violation of the FCC's Joint Cost Order rules (id. at 77-78, citing Exh. NECTA-169, March 15, 1994 FCC Time Reporting Audits at 6-7; Tr. 19, at 146-148). Claiming that NYNEX has not met its burden of justifying the charges, NECTA advocates that these expenses be removed from cost of service (id. at 78). Additionally, NECTA argues that NYNEX should be directed to quantify all of S&T's charges to TRG and remove them from cost of service (id. at 85, citing Exh. NECTA-218).

NECTA argues that $656,289 in TRG charges relating to VMS represents a nonregulated operation, and thus should not be included in cost of service (id. at 78, citing Exh. NECTA-154). According to NECTA, NYNEX has failed to demonstrate that a revenue credit approach for VMS would be equitable to telephone ratepayers. NECTA reasons that if VMS fails to provide a return at least equal to the allowed rate of return, customers would be forced to subsidize the service (id. at 78 n.21). Moreover, NECTA argues that by including these costs in the revenue requirement, these costs would be embedded in rates without affording customers the benefits possible by crediting VMS revenue growth (id.). Therefore, NECTA concludes that VMS expenses should be removed from cost of service (id.).

NECTA argues that $406,000 relative to S&T's wireless communications activities should be excluded from cost of service, because it represents a nonregulated operation (id. at 79-80, citing Exh. NECTA-218). In addition, NECTA argues that $2,686,000 in affiliate charges relative to broadband-related activities should be removed from service (id. at 80, citing Exh. NECTA-227; RR-NECTA-32; RR-NECTA-32 Supp.). In the alternative, NECTA proposes that these expenses be deferred in accordance with the recommendations of a report prepared by the National Association of Regulatory Utility Commissioners' ("NARUC's") Staff Subcommittee on Accounts, entitled "A Report on the Review of Bellcore Technical Work Efforts" (id. at 80, citing Exh. NECTA-215).[202]

NECTA proposes that at least $316,383 in Bellcore video project costs which it has identified on the record be removed from cost of service (id. at 84, citing RR-NECTA-4, Att. II). NECTA proposes that NYNEX be further directed to provide a full accounting of Bellcore charges relative to video and remove them from cost of service (id. at 84).

NECTA argues that $702,000 associated with NYNEX Corporation telecommunications planning activities should be removed from cost of service, because the Company has failed to demonstrate that these charges are properly assignable to monopoly customers (id. at 85, citing Exhs. NECTA-122; NECTA-125; Tr. 11 at 84-86). According to NECTA, NYNEX Corporation has failed to provide a breakdown of these charges on a project-specific basis, thus making it impossible to determine the propriety of these charges (id. at 85).

NECTA asserts that $1,477,699 in expenses relative to TRG's nonregulated planning activities should be removed from cost of service (id. at 91, citing Exh. NECTA-158). Also, NECTA argues

[202] The NARUC's Staff Subcommittee on Accounts recommended that Bellcore expenses should be capitalized if they were either directly associated with potentially competitive services, or common to noncompetitive and potentially competitive services (Exh. NECTA-215, at ii-iii).

that $1,342,300 in expenses relative to TRG's video and certain non-related functions should be excluded from cost of service (id., citing Exh. NECTA-160). According to NECTA, NYNEX has failed to demonstrate any reasonable allocation of these expenses to its tariffed intrastate operations, and, therefore, these expenses should be removed from cost of service (id.).

NECTA also contends that $336,511 in TRG charges associated with a multimedia trial are related to nonregulated or interstate operations, and, therefore, should be removed from service (id. at 92; citing Exh. NECTA-191). Additionally, NECTA argues that these trial costs represent nonrecurring expenses that warrant removal (id. at 92-93). In the alternative, NECTA proposes that these expenses be deferred until NYNEX offers multimedia service, at which time the trial costs can be directly assigned to multimedia customers (id. at 92).

(C) NYNEX

The Company contends that the Attorney General has improperly overstated and double-counted some of his proposed adjustments for broadband and video services. NYNEX contends that, contrary to the Attorney General's claim that some $6.6 million should be excluded from rates, there are only approximately $3.1 million in TRG, S&T, and Bellcore expenses related to broadband (NYNEX Reply Brief at 102 n.24, citing Exh. NECTA-227).

The Company argues that it has accounted properly for its TRG expenses relative to video and non-related functions, in accordance with FCC rules and regulations (NYNEX Brief at 260). NYNEX contends that neither the Attorney General nor NECTA has rebutted the Company's *prima facie* case on video, broadband, and wireless expenses (*id.* at 235). NYNEX maintains that the attempts of the Attorney General and NECTA to redefine their applications of VOD on reply briefs constitutes an inappropriate attempt to place upon the Company a burden of proof that could not be reasonably foreseen (NYNEX Reply Brief at 107). The Company maintains that the proposed adjustments, while ostensibly designed to eliminate expenditures for research on VOD service, are not based on any specific analysis (NYNEX Brief at 235). Rather, NYNEX suggests that NECTA's real concern is with the Company's emerging broadband projects (*id.* at 236).

In defense of its broadband and video expenditures, the Company explains that broadband services are not limited to VOD, but encompass a variety of technologies already used, including fiber distributed data interface, frame relay service, and fast packet service (*id.* at 236). According to NYNEX, the broadband network infrastructure cannot be equated with video service, because of its availability for voice and data transmission (*id.* at 237). The Company observes that mere identification of a particular project as "broadband" or "video-related" does not demonstrate that the project involved VOD, but other broadband and video services currently in use (id. at 238; NYNEX Reply Brief at 96-97). Further, NYNEX argues that NECTA has failed to rebut the FCC-approved allocation method, or offer its own method for consideration (NYNEX Brief at 261).

Moreover, NYNEX maintains that categorizing a project as "research" does not mean that the project has application to future service offerings. Rather, the Company argues that under FCC accounting rules, research and development encompasses both existing and proposed service offerings (id. at 238; NYNEX Reply Brief at 98-99). According to NYNEX, NECTA failed to establish the extent to which the Company's research activities involve VOD (NYNEX Brief at 239).

Even if certain charges could be considered VOD-related, NYNEX argues that the expenses are justified in cost of service (id. at 239). First, the Company argues that the FCC's accounting requirements direct that research and development expenses be charged off against expenses (id. at 239-240, citing 47 C.F.R. §§ 32.5999, 32.6727(a); SFAS No. 2, at 12; NYNEX Reply Brief at 101). NYNEX notes that the Department has rejected prior attempts to adopt a "pinched view" that research for future services, such as those performed by Bellcore, be booked to deferred accounts (NYNEX Brief at 240, citing D.P.U. 86-33-G at 177). The Company further notes that the NARUC staff subcommittee report contained in Exhibit NECTA-215 was never adopted by either the FCC or the NARUC (id. at 245 n.67, citing Tr. 20, at 27-28). Second, NYNEX rejects the idea that VOD and video transport services are purely interstate in nature, noting that the FCC has ruled that intrastate services of this nature may properly be subject to state regulation (id. at 242-243). NYNEX argues that because the FCC has already determined that VOD can be subject to state regulation as an intrastate service, VOD service offers benefits to intrastate ratepayers (id. at 244; NYNEX Reply Brief at 105).

As to the specific projects NECTA proposes for deletion, NYNEX contends that NECTA failed to provide any factual basis for its recommendation or for the recommendation's consistency with Department precedent (NYNEX Brief at 249-250). NYNEX states that it has already conceded that $513,000 in New York video dial-tone trial expenses should be removed from cost of service (id. at 248, citing Tr. 11, at 44). The Company defends its inclusion of its other affiliated transaction expenses in cost of service, as further described below.

The Company contends that its VOD charges from TRG also relate to new transport technologies, and that NECTA has no basis on which to conclude that all of the charges relate to VOD service (id. at 244). Even assuming that VOD service expenses were excludable, NYNEX maintains that NECTA failed to demonstrate what portion of the charges were related to VOD service (id.).

The Company contends that the broadband prototype applications and services identified in Exhibit NECTA-181 concern technical support for the standardization, development and transfer of new broadband technology into the NYNEX network, and are not confined to, or even refer to, video or video transport (id. at 246). NYNEX holds that the terms "video" or "video transport" are not limited to VOD, but to other existing and future non-VOD transmission of video images (id.). Finally, NYNEX argues that, as discussed supra, VOD can be an intrastate service and thus subject to state regulation (id.).

Turning to its twisted cable trial charges, NYNEX first notes that, as it has stated earlier, video transport or video dial-tone is potentially an intrastate service (id. at 246-247). Addressing NECTA's argument that the expense is nonrecurring, the Company responds that research is valuable, even if it does not lead to use in the network of a particular technology (id. at 247). NYNEX goes on to suggest that research that proves a given technology will not be satisfactory could be among the most valuable research results obtained, and because a particular research project produced unsatisfactory results should not be the basis for excluding the research costs (id. at 247). The Company notes that the Department has previously rejected attempts to exclude "nonrecurring" research expenses from cost of service (id., citing D.P.U. 86-33-G at 189-190).

The Company defends its payments to TRG for S&T projects by replying that NECTA has failed to provide any basis for its proposed adjustments (id. at 248). NYNEX contends that the $8.05 million encompasses all TRG research and development costs, including projects that are in no way connected to "future nonregulated and video service" (id. at 248-249). The Company argues that NECTA fails to provide any basis on which to support its "recommended" elimination of expenses relative to the ten projects enumerated in Record Request NECTA-24 (id. at 249).

NYNEX defends its S&T overhead costs, contending that these were assigned to regulated and nonregulated operations in accordance with FCC Part 64 rules (id. at 249-250). NYNEX attacks NECTA's reliance on Exhibit NECTA-169, replying that this actually advises the Company to revise its overhead allocations to reflect direct assignment, and does not state that overhead costs had been apportioned exclusively to regulated operations (id. at 250). Because NYNEX claims there is no basis for removing even its nonregulated expenses from cost of service, there is no basis to support removing S&T overheads from cost of service (id.).

According to the Company, the work associated with its wireless communications expenses relates to local loop, craft access systems, and new network-related wireless technologies, which directly benefits regulated network customers (id. at 251-252). NYNEX maintains that there is no basis behind NECTA's proposed exclusion from cost of service (id. at 252).

Concerning its broadband network development expenses, NYNEX argues that NECTA's reliance on Exhibit NECTA-227 is misplaced, because the exhibit refers broadly to broadband service as a technology presently used to transport information of all types (id.). Thus, the Company holds that there is no basis for NECTA's proposed adjustment (id. at 253).

The Company takes issue with NECTA's proposed Bellcore-related adjustments. NYNEX argues that video transport, including VOD, is both interstate and intrastate in nature, and thereby qualifies for state regulation (id.). Thus, NYNEX concludes that there is no basis to support NECTA's proposed Bellcore adjustments (id. at 253-254).

The Company defends its NYNEX Corporation telecommunications planning expenses, stating that these charges relate to executive oversight and planning, and that project-specific identification is not possible or sensible (id. at 255). NYNEX holds that the costs at issue have been properly assigned to both regulated and nonregulated operations consistent with the requirements of the FCC and the Company's Cost Allocation Manual (id.).

ii. Analysis and Findings

G.L. c. 159, § 12, gives the Department broad authority over common carrier services. Section 12 states in pertinent part:

> The [D]epartment shall, so far as may be necessary for the purpose of carrying out the provisions of law relative thereto, have general supervision and regulation of, and jurisdiction and control over, the following services, when furnished or rendered for public use within the [C]ommonwealth ... [t]he transmission of intelligence ... by electricity, by means of telephone lines or telegraph lines or any other method or system of communication, including the operation of all conveniences, appliances, instrumentalities, or equipment appertaining thereto, or utilized in connection therewith.

Thus, the general supervisory power of the Department is broad with respect to carriers furnishing service for public use. Both the Attorney General and NECTA identified a number of affiliated expenses that they contend should be deleted from cost of service, alleging that they relate to broadband, video activities, or nonregulated operations. The parties, particularly NECTA, have submitted extensive argument on brief as to the nature of broadband and video. In view of this, and the importance of the issue, the Department shall address the issue of broadband and video in general. We note that the FCC rulings on the ratemaking treatment of prospective video dial-tone costs does not support NECTA's argument that all video-related R&D expenses should be deferred. Accordingly, we find NECTA's arguments in this regard to be without merit.

The Attorney General and NECTA aver that the Company's direct payments to S&T, as well as those made by way of TRG, related to Data and Information Services, Prototype Applications and Services, and Transmission and Video Systems, involve broadband activities that provide no useful service to telephone customers. For the same reason, the parties propose that an additional $2,686,000 in S&T broadband charges should be excluded from cost of service. NYNEX is currently using broadband technology, including fiber distributed data interface, frame relay service, and fast packet service, in its network (Exhs. NECTA-227; NECTA-196, Impact, Summer 1993, at 23). Contrary to the contentions of NECTA and the Attorney General, the existence of a broadband network infrastructure does not presuppose the existence of video service, because of broadband's availability to transmit both voice and data. It thus follows that merely identifying a particular project as "broadband" or "video-related" does not conclusively demonstrate that the project is not also related to telephone services.

The record demonstrates that the TRG and S&T prototype applications and services identified in Exhibit NECTA-181 involve technical support for the standardization, development and transfer of new broadband technology into the NYNEX network without distinction between broadband and video (Exh. NECTA-181). Likewise, the $1,216,000 in S&T's data and information services involves broadband infrastructure support (Exh. NECTA-180). The Department finds that, for purposes of determining the reasonableness of the Company's current earnings, neither the

Attorney General nor NECTA has provided sufficient justification to exclude these expenses from cost of service. Turning to the Company's S&T charges for transmission and video systems, the record demonstrates that $34,000 in direct S&T charges under this activity represent equipment testing expenditures (Exh. NECTA-182). S&T allocated an additional $554,000 to TRG, which in turn was charged to the Company, associated with new transport technologies, including wireless communications and VOD service (id.; Exh. NECTA-174). Even assuming that VOD and VOD-related activities should somehow be removed from NYNEX's cost of service, the record does not indicate the extent to which S&T's research activities involve VOD. Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects the parties' proposed adjustment for this item.

As an alternative to excluding broadband- and VOD-related expenditures from cost of service, NECTA proposes that NYNEX book these research and development expenses to deferred accounts. We do not agree that these expenditures relate only to future services. Since NYNEX's end users benefit from the Company's network development and planning activities, they receive a corresponding benefit from these activities. See NET, D.P.U. 86-33-G at 190 (1989). Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects NECTA's proposed deferral of the Company's broadband expenditures.

With respect to NYNEX's multimedia trial expenditures of $336,511, the Department notes that the Company's multimedia trial is ongoing and providing service to the customers involved in the project (Exh. NECTA-191). Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects NECTA's and the Attorney General's proposed exclusion of this expense from cost of service, as well as NECTA's proposal to defer the expense.

On brief, NECTA and the Attorney General suggested that $183,000 in expenses related to NYNEX's twisted cable trial be disallowed as either a nonregulated service or as a nonrecurring expense. The Department finds no merit in the proposal. The twisted cable trial concluded that the technology being examined therein would not prove to be a success. As we have noted above, telecommunications technology has changed to a greater extent than gas, electric, or water technology. As a technology-driven industry, telecommunications companies have an ongoing need to engage in research projects intended to result in new or improved services. Thus, a telecommunications company may be engaged in a far greater number of research activities on an ongoing basis than is the case with other utilities. Subsequently, some research projects may end up not being adopted by the utility because the technology was found to be inadequate to meet the intended need. While an individual project technically may be considered as a failure, it does not follow that the costs of that research were incurred imprudently or were otherwise nonrecurring.[203] The Department finds that NYNEX is currently involved in a number of research projects, including the twisted cable trial at issue here, that cannot be characterized as either extraordinary or nonrecurring in nature or amount. Boston Gas Company, D.P.U. 1100, at 95 (1982). Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects the Attorney General's and NECTA's proposed disallowance of this expense.

With respect to the $4,870,200 in expenses associated with the ten projects enumerated in Exhibit NECTA-128 and Record Request NECTA-24, the record demonstrates that NECTA fails to support its argument that these projects relate to nonregulated endeavors. NECTA's cross-examination on this subject was limited to obtaining the complete project names for those activities specified in Exhibit NECTA-128 (Tr. 11, at 81-84). NECTA failed to further inquire into the nature of the projects identified in Record Request NECTA-24. The project titles provided with the

[203] In fact, the Department has emphasized the need for utilities to conduct appropriate research into proposed technologies. Boston Gas Company, D.P.U. 93-60, at 27-30 (1993).

total cost of the projects at issue do not rise to an evidentiary level necessary to establish whether the activities represented therein are associated with non-jurisdictional operations. Moreover, to the extent that these activities involve nonregulated operations, we have reflected this in our treatment of nonregulated operations in Section VII.C.15.b, supra. Accordingly, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects NECTA's proposed adjustment.

NECTA contests the inclusion of $316,383 associated with Bellcore expenditures in the Company's cost of service. The Department has previously examined the nature of Bellcore expenditures, and found it inappropriate to book expenses relative to research for future services, such as those performed by Bellcore, to deferred accounts. D.P.U. 86-33-G at 188-192. While the NARUC staff subcommittee report contained in Exhibit NECTA-215 has been admitted into evidence, we agree with the Company that it should be accorded little weight in this proceeding. The report therein was never adopted by either the FCC or by the NARUC (Tr. 20, at 27-28). Accordingly, the Department finds that NECTA has failed to provide a basis for its proposed adjustment, and, for purposes of determining the reasonableness of the Company's current earnings, we reject NECTA's proposal.

With respect to the $702,000 in expenses associated with NYNEX Corporation's telecommunications planning functions, the record demonstrates that these costs have already been apportioned between regulated and nonregulated activities in accordance with the Company's procedures. The Department has found that NYNEX's expenditures connected with its nonregulated services have been accounted for through the allocations in the Cost Allocation Manual. NECTA has provided no evidence or argument to indicate that the expenses at issue here have not been allocated through the Cost Allocation Manual. Accordingly, the Department shall make no further adjustment for this item.

Both NECTA and the Attorney General have identified a number of expenditures that they contend are more properly considered to be related to the Company's nonregulated operations. Specifically, they dispute the inclusion of NYNEX's Wireless Communications lab expenditures and $656,289 in TRG expenses related to VMS. NECTA further identifies $3,950,000 in S&T overhead costs, $1,477,699 in TRG's nonregulated costs, and $1,342,300 associated with TRG's video activities, that it contends should be excluded from the Company's cost of service. As noted in Section VII.C.15.b.iii, supra, the Department has found that NYNEX's expenditures connected with its nonregulated services have been accounted for through the allocations in the Cost Allocation Manual. There is no evidence to suggest that the expenses at issue here have not been allocated through the Cost Allocation Manual. Insofar as the Department has already adjusted the Company's expenses to reflect the treatment of other nonregulated services, we find that, for purposes of determining the reasonableness of the Company's current earnings, no further adjustment is required.

17. Management Salaries

a. Introduction

The Company proposed to adjust its cost of service by $935,000 for first level management salary increases and $7,673,000 for union salary increases that were implemented during the 1993 study period, and $2,742,000 for first level management increases and $4,992,000 for union salary increases during 1994. The Company normalized these adjustments in order to match the salary increases for first level management beginning on April 1 of each year, and for the unions beginning on August 8 of each year with the 1993 and 1994 calendar years (Exhs. NYNEX-9, Att. 5, at 15-16; MCI-14, at 9-10; RR-AG-51). The Company defined first level managers as those who supervise union and non-union employees or those who are task workers, such as secretaries (Tr. 10, at 28).

b. Positions of the Parties

i. Attorney General

The Attorney General does not contest the Company's adjustments for 1993 salary increases or 1994 union increases. However, the Attorney General recommends reducing the Company's cost of service by the amount of the 1994 management salary increase, which is $2,742,000 (Attorney General Brief, Part II, at 30). According to the Attorney General, the Company's proposed 4.39 percent management salary increases for 1994 should be disallowed because: (1) they are estimates that are not based upon a contract (id. at 28); (2) they are unreasonable in size when comparing the Company's 1993 and 1994 management increases to the consumer price index in each of those years (id. at 29); (3) they have not been substantiated by the Company by a showing that they are comparable to pay for similar employees of the other RHCs, including those in urban areas -- moreover, they are 10 percent higher than salary increases for those employees (id., citing Exhs. AG-618, AG-620; Attorney General Reply Brief at 51); and (4) they have not been compared to studies of region-wide or nation-wide non-union salaries (id. at 29). The Attorney General also points out that the Department previously has denied similar proposed salary increases when studies were not submitted that demonstrated the reasonableness of the proposed total non-union payroll expenses in comparison to companies in the service territory where the company competes for similarly-skilled people (id., citing Cambridge Electric Light Company, D.P.U. 92-250, at 36-40 (1993)).

ii. NYNEX

The Company puts forth several arguments to counter the Attorney General's assertions. First, NYNEX argues that the only increase included in the cost of service is for "first level" management personnel -- employees who either directly supervise operating personnel or are themselves task workers (NYNEX Brief at 194). Second, the Company asserts that the Department does not require a contract for non-union personnel, but an express commitment by management that demonstrates that the increase is known and measurable (id. at 194-195, citing Fitchburg Gas and Electric Light Company , D.P.U. 1270/1414, at 14 (1983)). The Company asserts that documentation of the commitment was provided (id. at 195, citing Exh. AG-627). Third, NYNEX contends that the Attorney General's argument that the Company's salaries are 10 percent above the average pay for similar employees of the other RHCs fails to recognize that the increases refer to first level and other managers and include data from not just New England Telephone but all of NYNEX, including those managers that work in New York City (id. at 196; NYNEX Reply Brief at 78). NYNEX claims that the figure reflects the differences in the cost of living between NYNEX's service territory and other parts of the country (NYNEX Brief at 196). Fourth, the Company maintains that the increases are consistent with the size of recent increases for other utility companies (id. at 197, citing Bay

State Gas Company, D.P.U. 92-211, at 96-99 (1993); Berkshire Gas Company, D.P.U. 92-210-C at 6 (1993); and Massachusetts Electric Company, D.P.U. 92-78, at 20 (1992)). Fifth, NYNEX contends that, unlike union employees, management employees pay a portion of their health insurance, so their salary levels should reflect that (id.). Sixth, NYNEX maintains that the increase incorporates a step element and a cost-of-living element (id. at 197-198). Seventh, the Company claims that the Attorney General did not challenge the increase on the record and since this is not a general rate case, NYNEX should not be penalized for failing to provide the nation- and region-wide studies of salaries, as required in previous Department rate cases (id.). Finally, the Company points out that the proposed adjustment for first level management salaries and union salaries in the instant case is similar to the adjustment presented and found to be known and measurable in the Company's last rate case, and that it was not challenged by any party in that case or in the instant proceeding (id. at 199-200, citing D.P.U. 86-33-G at 223). Therefore, the Company argues that the Attorney General's adjustment should be denied.

c. Analysis and Findings

The Company is correct that non-union salary increases are not linked to any contract. Department standards require that the increase must be expressly committed to by management, be correlated to union increases, and be reasonable. Boston Gas Company, D.P.U. 93-60, at 94 (1993); Massachusetts Electric Company, D.P.U. 92-78, at 24 (1992); and Fitchburg Gas and Electric Light Company, D.P.U. 1270/1414, at 14 (1983). Exhibit AG-627 provides a commitment to the raise, which satisfies part one of our standard.[204] The union increases are 4.04 percent and correlate to the management increase, which satisfies part two of our standard (Exh. MCI-14, at 10).

The reasonableness of the increase can be determined by examining the surveys provided by the Company in Exhibit AG-624. The 1993/94 Geographical Salary Differential Report indicates that base salaries using $40,000 as the base salary level are 8.8 percent higher in Boston than the national average. Also, the 1994 average projected increase for executives was 4.6 percent, which is slightly higher than the percentage increase proposed by the Company (Exh. AG-624). The Attorney General is correct that the Company has the burden of proving the reasonableness of its proposal, and that the Company did not submit all of the comparative analyses required by the Department. Compare D.P.U. 92-78 and D.P.U. 92-250 with Exh. AG-624. However, the Company did provide several surveys in support of its salary increase. Given the unique nature of this case, the Department

[204] The commitment did not address the "step" increase that brings managers in line with their years of service (Exh. AG-627).

finds sufficient the evidence provided by the Company in support of the first level management salary increase. Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department rejects the Attorney General's proposed adjustment.

18. Royalty Payments

a. Positions of the Parties

i. Attorney General

The Attorney General argues that an adjustment must be made to the cost of service to reflect the uncompensated use of certain intangible assets and benefits[205] by the Company's unregulated affiliates and, thereby, prevent ratepayers from subsidizing these affiliates (Attorney General Brief, Part II, at 51). The Attorney General claims that not only has NYNEX transferred intangible property to subsidiaries, it also has provided financial support (e.g., letters of credit), transferred employees to other NYNEX affiliates, and misallocated costs as a result of the NYNEX diversified businesses (id. at 51-55). The Attorney General maintains that cost allocation procedures and limits on affiliate transactions do not adequately protect NYNEX ratepayers from harm due to NYNEX diversification (id. at 51).

[205] The Attorney General claims these benefits include the Company's reputation, its identifying logo and trademarks, the skills and experience of its personnel, and access to its consumer markets (Attorney General Brief, Part II, at 51).

The Attorney General asserts that the use of intangible assets and benefits demonstrates the need to protect ratepayers from the effects of diversification whether deliberate or not (id. at 55).

The Attorney General claims that the independent management audit ordered by the Department in D.P.U. 86-33-G does not address the regulated utility's incentive to shift costs from its competitive to its monopoly operations (Attorney General Reply Brief at 64). The Attorney General maintains that ratepayers are entitled to the same protection in this instance as would be afforded them when an asset is transferred to an unregulated affiliate for less than fair market value (Attorney General Brief, Part II, at 55). The Attorney General claims that Mr. McQuaid indicated that neither NYNEX nor NYNEX-New England (i.e., NET)[206] would allow an unrelated third party to use the Company's trade name and trademarks without compensation (id. at 54). The Attorney General argues that ratepayers are entitled to have NYNEX compensated to the same degree as it would be if an unaffiliated company were to use its name and reputation (id. at 55).

The Attorney General argues that a royalty adjustment is needed as the remedy for misallocations that exist and could only

[206] The Attorney General maintains that the fact that affiliates may be using the NYNEX name rather than the NET name is meaningless and notes that the New York Public Service Commission ("NYPSC") has rejected such a distinction (Attorney General Brief, Part II, at 54).

be discovered through the expenditure of valuable regulatory time and resources (Attorney General Reply Brief at 65). The Attorney General maintains that the New York Public Service Commission ("NYPSC") has determined that NYNEX subsidiaries have received benefits from NYT, and that where the asset is used and no revenues are received in exchange, an imputation of revenues is warranted (Attorney General Brief, Part II, at 52).

The Attorney General claims that the NYPSC adopted a generic policy of imputing a royalty payment on the total capitalization of a utility's unregulated subsidiaries to reflect the uncompensated use of intangible assets and other costs not readily or directly quantified (id. at 51-52, citing In Re Rochester Telephone Corporation , 145 P.U.R. 4th 419 (N.Y.P.S.C., 1993), aff'd In Re Rochester Telephone Corporation v. Public Service Commission of the State of New York , 614 N.Y.S. 2d 454 (A.D. 1994)). The Attorney General maintains that even though this issue is on appeal in New York, the decision of the NYPSC and the court is valid in that jurisdiction (Attorney General Reply Brief at 63).

The Attorney General maintains that the NYPSC created a rebuttable presumption that a 2 percent royalty payment will be imputed for ratemaking purposes with respect to a utility's investment in competitive enterprises (Attorney General Brief, Part II, at 53, citing In re Rochester Telephone Corporation , 145 P.U.R. 4th at 443). The Attorney General indicates that the NYPSC subsequently determined that because of NYT's restructuring plan ("The Plan for Comprehensive Restructuring of NYNEX Corporation and its Affiliates" ("Affiliated Plan")), which included a diminution in the number of affiliate transactions, and the enactment of a 25 percent employee transfer fee, circumstances warranted reducing the royalty payment to 1.33 percent (id. at 54). Therefore, the Attorney General argues, the NYPSC has already taken into consideration the changes that resulted from the restructuring plan, and, consequently, there is no basis to further reduce the requested adjustment (Attorney General Reply Brief at 64).

The Attorney General maintains that the Department, pursuant to G.L. c. 159, § 34A, has the same obligation to protect ratepayers from improper transactions between a utility and its affiliates as does the NYPSC (Attorney General Brief, Part II, at 52). The Attorney General argues that there is a need for a royalty imputation in this case, and the Department should use the 1.33 percent level applied to NYT by the NYPSC (id. at 54). Therefore, the Attorney General asserts, the cost of service should be decreased by the imputation of royalty payments in the amount of $2,812,000 (id. at 55).

ii. NYNEX

The Company contends that the Attorney General's reliance on the NYPSC's policy of imputing a royalty payment is flawed because the NYPSC policy is still on appeal (NYNEX Brief at 223). The Company argues it would be premature for the Department to adopt a policy under judicial review (id. at 224).

The Company also maintains that the Department has already addressed this issue in D.P.U. 86-33-G, wherein the Department ordered an independent audit of the functional and financial relationships among the Company and its affiliates (id.). In addition, the Company claims that the Affiliated Plan significantly curtails and governs the transactions between and among NYNEX companies (id.). NYNEX argues that, given the comprehensive information provided in the management audit and the Affiliated Plan, the Department need not rely on the imprecise NYPSC approach (id. at 225). The Company notes that the only affiliate that uses the Company's name, NIRC, makes a substantial payment to the Company for that right (id., citing Tr. 17, at 62). The Company argues that there is no evidence or other basis for imputing additional payments to the Company and, therefore, the Attorney General's adjustment should be rejected (id.).

b. Analysis and Findings

While Mr. McQuaid acknowledged that the Company believed its name had value and had received payments for its use only from NIRC, there is no evidence to indicate the extent to which other affiliates use the name or to estimate the value, if any, that is derived from its use. Regarding the claim that costs have been misallocated, the only record evidence indicates that the Company itself deleted costs when it realized that such were not allowed by the FCC (Tr. 17, at 60). It is not apparent from the record whether, or to what extent, current allocation procedures are inadequate in this respect. Therefore, based on the evidence in this case and for purposes of determining the reasonableness of the Company's earnings, the Department does not allow the Attorney General's proposed adjustment for royalty payments.

19. Productivity Adjustment to Inflation Allowance

a. Introduction

The Company did not propose an inflation allowance. Nevertheless, the Attorney General proposed on brief a productivity adjustment to an inflation allowance, which he contends would more accurately reflect the Company's cost savings activities (Attorney General Brief, Part II, at 56-59).

b. Positions of the Parties

i. Attorney General

The Attorney General states that the Department allows utilities to make pro forma adjustments to the cost of service for the forecasted effect of inflation on their operations and maintenance expenses (id. at 56, citing Commonwealth Electric Company, D.P.U. 956, at 36-41 (1982)). The Attorney General claims that the productivity adjustment that he is seeking is for future productivity changes that occur between the test year and the year that rates are in effect (Attorney General Reply Brief at 66). The Attorney General maintains that NYNEX's productivity improvement over the period in which the inflation adjustment is calculated also affects the Company's costs (Attorney General Brief, Part II, at 57). The Attorney General argues that the forecasted improvement in productivity over and above the productivity improvement in the economy should be deducted from the change in the price index (id., citing Exh. AG-795). The Attorney General contends that the additional productivity improvements for NYNEX cause the net effect to be deflationary rather than inflationary (id. at 56). Therefore, the Attorney General argues that the Department should order a productivity component of 5.2 percent [207] in an inflation adjustment, which would reduce the Company's revenue requirement by $18,653,000 [208] (id. at 59).

ii. NYNEX

The Company claims that the Attorney General is requesting a "deflation" adjustment that, based on off-record computations,

[207] 5.2 percent is the productivity offset (minus the stretch component) recommended by the Attorney General's witness, Dr. Selwyn, for use in the price cap formula.

[208] Based on computations contained in Attorney General Brief, Part II, at 58.

would result in an $18,653,000 decrease to cost of service (NYNEX Brief at 225-226). The Company maintains that the Attorney General's proposal to include a productivity factor in the inflation adjustment suffers from two flaws (id.). First, making such an adjustment conflicts with Department precedent on inflation allowances because NYNEX claims that the Department has never allowed the inflation forecast to be offset by anticipated productivity (id.). The Company contends that all "known and measurable" future productivity factors are already taken into account elsewhere in the cost of service (id.). The Company argues that, if the Attorney General's 5.2 percent productivity factor is eliminated from the calculation, the results yield a positive inflation adjustment of $17,271,000, which is the sort of adjustment the Company would have sought if this were a rate case (id.).

Second, the Company maintains that the Attorney General's proposal is already contained in the price cap plan (id. at 227). According to the Company, the Plan contains an offset for productivity that is designed to counteract inflationary pressures over the course of the Plan (id.).

c. Analysis and Findings

The Department permits utilities to increase their test year operation and maintenance expenses not separately adjusted in the cost of service by the projected gross national product implicit price deflator ("GNPIPD") for the period from the midpoint of the test year to the midpoint of the first twelve-month period when the new rates would be in effect. Massachusetts Electric Company, D.P.U. 92-78, at 60 (1992); Western Massachusetts Electric Company, D.P.U. 89-255, at 52 (1990).

As noted, the Company did not propose such an adjustment in this case although in his brief the Attorney General proposes not only an inflation allowance but an adjustment to include a productivity offset. It was improper to introduce an inflation adjustment for the first time on brief - no parties had the opportunity to address this. Therefore, for purposes of determining the reasonableness of the Company's current earnings, the Department denies the inflation allowance adjustment proposed by the Attorney General.

20. Financial Accounting Standards 87 and 106 Accrual Expense

a. Introduction

The Company has included pension expenses and PBOP expenses in its cost of service based on the accrual amounts determined under Financial Accounting Standard 87 ("FAS 87") and Financial Accounting Standard 106 ("FAS 106"), respectively (Exh. NYNEX-44).[209] The amount determined under FAS 87 is

[209] For consistency in referring to amounts used in this section, the Department will use the amounts shown on Exhibit NYNEX-44.

($21,442,156), [210] while the amount determined under FAS 106 is $61,631,486. [211] The pay-as-you-go ("PAYG") amount for 1993 is $34,937,853. [212] The result is that in the 1993 study period the Company included in its cost of service a net incremental intrastate expense of $5,251,477 [213] to reflect FAS 87 and FAS 106 level of expense (Tr. 13, at 121; Exh. NYNEX-44).

b. Positions of the Parties

i. Attorney General

The Attorney General maintains that the Department's precedent regarding PBOPs is well established (Attorney General Brief, Part II, at 30, citing Boston Gas Company, D.P.U. 93-60, at 214 (1993); Cambridge Electric Light Company, D.P.U. 92-250, at 54 (1993); Massachusetts Electric Company, D.P.U. 92-78, at 83-84 (1992)). The Attorney General maintains that under this precedent, companies are required to set aside funds in a trust fund designated for PBOP costs in order to recover these amounts from ratepayers (id. at 31).

The Attorney General contends that the Company did not make

[210] ($27,962,438) X .76682 = ($21,442,156) (Exh. NYNEX-44).

[211] $80,372,821 X .76682 = $61,631,486 (Exh. NYNEX-44).

[212] $45,562,000 X .76682 = $34,937,853 (Tr. 13, at 119; Exh. NYNEX-44).

[213] The net increase over the PAYG amount for PBOP. $61,631,486(FAS 106) - $21,442,156 (FAS 87) = $40,189,330 - $34,937,853(PAYG) = $5,251,477 (Exh. NYNEX-44).

a contribution to a fund during the test year and has not established a separate designated trust fund (id., citing Exh. AG-584). The Attorney General argues that without this separate fund and the corresponding cash contributions, ratepayer funds are not secure, and there is no assurance that the money will be available to pay out benefits in the future (id.). Therefore, there should be no recovery (id.).

The Attorney General initially argued that the PBOP amount allowed in rates should be reduced from the FAS 106 accrual of $61,631,486 to the PAYG amount of $34,937,853, thereby decreasing the revenue requirement by $26,693,633 (id., citing Tr. 13, at 119). The Attorney General subsequently argued that the cost of service should be reduced by the PBOP accrual of $61,631,486 and increased by $21,442,156 to eliminate the negative pension accrual (Attorney General Reply Brief at 52). The Attorney General now maintains that, since the Company does not have to make any payments to the PBOP trust and the pension trust can meet the cash needs for PBOPs, the Company does not have to make the PAYG cash payments (id. at 53). Therefore, the Attorney General argues that cost of service should be reduced by $40,189,330[214] (id.)

ii. NYNEX

The Company maintains that the Attorney General's analysis

[214] $61,631,486 - $21,442,156 = $40,189,330

is one-sided (NYNEX Brief at 200). NYNEX contends that the Attorney General ignores the negative expense accrual pertaining to the Company's pension fund (id.). The Company argues that if one side of the balance sheet is recognized, the other side also must be recognized (id. at 201). NYNEX states that in early 1993 the Company approached the Department about offsetting the FAS 106 PBOP accrual against the negative FAS 87 pension accrual in order to minimize creation of regulatory assets and liabilities, and to comply with GAAP, on a revenue neutral basis (id. at 201, citing Tr. 13, at 102-106). The Company argues that while a concern about future ratepayers is the reason for the Massachusetts Electric rule requiring funded PBOP accounts, it does not apply to the circumstances in this case because a shortfall in PBOPs is not an "exogenous factor" that can be charged under the Company's Alternative Regulation Plan (id. at 201-202, citing Massachusetts Electric Company , D.P.U 92-78 (1992)).

The Company maintains that the Attorney General's assertion that the Company does not have to make PAYG cash payments is wrong (NYNEX Reply Brief at 79). The Company states that its witness testified that "retirees are paid out of current operating cash flow" (id., citing Tr. 13, at 88-89). The Company argues that its proposal to adopt accrual accounting for ratemaking purposes and to offset FAS 87 against FAS 106 is an optimum solution with a modest incremental intrastate expense of $5,300,000 (id.).

NYNEX argues that the Attorney General's proposed adjustment should be disregarded because the FAS 106 and FAS 87 accruals essentially offset one another, and if there are future shortfalls, they would be the responsibility of the Company (NYNEX Brief at 202).

c. Analysis and Findings

The Department has previously held that financial accounting standards do not automatically dictate ratemaking treatment. Boston Gas Company , D.P.U. 93-60, at 212 (1993); Western Massachusetts Electric Company , D.P.U. 85-270, at 118-119 (1986). The Department is charged with setting just and reasonable rates for companies within our jurisdiction. The Department does not permit accounting standards alone, whether or not accepted by the Financial Accounting Standards Board, to determine our treatment of expenses. Boston Gas Company , D.P.U. 93-60, at 212 (1993); Western Massachusetts Electric Company , D.P.U. 85-270, at 118-119 (1986).

In response to FAS 106, the Department must decide what portion of the current and future PBOP obligation will be recovered through current rates. FAS 106 expense is derived from actuarial estimates that are based on many assumptions. The Department has serious concerns regarding the uncertainties surrounding FAS 106, especially regarding the impact of several potentially volatile factors, including: inflation, discount and investment rates; medical cost predictions; and medical trend assumptions. In addition, the potential for government intervention in the health care field and future technological changes give rise to enormous uncertainties regarding the future level of the Company's PBOP obligation. Furthermore, while a nonregulated company has an incentive to reflect as small an expense as possible for PBOP costs, the reverse is true for a regulated company. D.P.U. 93-60, at 213; Massachusetts Electric Company, D.P.U. 92-78, at 82 (1992).

The evidence indicates that the Company has established Voluntary Employees' Benefit Association ("VEBA") Trusts, one for management and one for non-management, to begin prefunding post-retirement health care benefits (Exh. AG-460, NET Form 10-K for the fiscal year ended December 31, 1993; Exh. AG-584). In 1991 and 1992, the Company transferred a portion of excess pension assets from the two NYNEX pension plans to health care benefit accounts established within the pension plans and then contributed those assets to the VEBA Trusts (Exh. AG-460, NET Form 10-K for the fiscal year ended December 31, 1993, at 39). The record also indicates that no cash contributions were made to the post-retirement benefits plan in 1993 (Exh. AG-584). During the study period the Company incurred $34,937,852 in PAYG payments.

The Department has linked recovery of PBOP to tax deductible amounts. D.P.U. 93-60, at 214-215; D.P.U. 92-78, at 83. Based on the evidence in this case and for purposes of determining the reasonableness of the Company's earnings, the Department will include PBOP in rates based on the PAYG amount. Therefore the Department disallows the FAS 106 PBOP accrual of $61,631,486.[215]

The Department has held that test year tax-deductible cash pension plan contributions that are demonstrated to be annually recurring may be included in rates. D.P.U. 93-60, at 234; Western Massachusetts Electric Company, D.P.U. 89-255, at 22 (1989). The Company did not make a cash contribution to the pension fund during 1993 (Tr. 13, at 118). Therefore, based on the evidence in this case and for the purposes of determining the reasonableness of the Company's earnings, the Department disallows the negative pension expense of $21,442,157 computed under FAS 87. This results in a corresponding increase to total expenses.

The net effect of the above findings is to decrease the cost of service by the amount of $5,251,477.

21. Payments to New England Legal Foundation

a. Introduction

NYNEX included in its initial filing a $15,075 expense for

[215] $80,372,821 X .76682 = $61,631,486 (Exh. NYNEX-44).

payments to NELF. The record does not indicate the reason NYNEX made these payments. NECTA proposes that the payments be disallowed in full.

b. Positions of the Parties

i. NECTA

NECTA claims that the Department should disallow the $15,075 payment to NELF (NECTA Brief at 90).

ii. NYNEX

The Company agrees that its payments to NELF should be excluded, but argues that the intrastate portion is $7,189 (NYNEX Brief at 265).

c. Analysis and Findings

The parties agree that this item should not be included in the cost of service. It appears that the Company is correct about the amount. Exhibit NECTA-148 indicates that the $15,075 represents the total NYNEX amount before application of the Massachusetts allocator and then the intrastate allocator. Therefore, based on the evidence in this case and for the purposes of determining the reasonableness of the Company's earnings, the Department will exclude $7,189 from expenses.

22. Charges from NYNEX Government Affairs

a. Positions of the Parties

i. NECTA

NECTA argues that NYNEX Government Affairs costs charged to the Company must be disallowed because of the failure of NYNEX to allocate these costs between regulated and nonregulated activities (NECTA Brief at 91, _citing_ Exh. NECTA-159).

ii. NYNEX

NYNEX maintains that the costs in question are accounted for and allocated in accordance with the applicable FCC Rules and Regulations, citing Part 64 and Part 36 (NYNEX Brief at 260).

b. Analysis and Findings

The Department finds that there is insufficient evidence to support NECTA's proposed adjustment. The evidence indicates that these expenses are accounted for in accordance with applicable FCC Rules and Regulations and the NYNEX Cost Allocation Manual (Exhs. NECTA-159; AG-484, at 3). NECTA has not identified specific costs to be disallowed nor cited evidence to challenge the allocation of costs by the Company. Therefore, based on the evidence in this case and for the purposes of determining the reasonableness of the Company's earnings, NECTA's proposed adjustment is disallowed.

C. Capital Structure and Rate of Return

1. Capital Structure

a. Introduction

As a multi-state consolidated system, NYNEX does not maintain a separate capital structure for its intrastate Massachusetts operations (Exh. AG-543, Att. 5, at 22).

Therefore, NYNEX relied on its consolidated capital structure to determine its required return on rate base (Tr. 12, at 38-39). at the end of its test year, NYNEX reported that its total capital structure consisted of $2,085,921,000 in long-term debt and $3,018,994,000 in common equity (Exh. NYNEX-10, exh. C). The long-term debt component included $2,180,000,000 in long-term debt and $3,689,000 in capital lease obligations, less $20,526,000 in debt discount and $77,242,000 in unamortized issuance expenses and call premiums (id.). Thus, NYNEX's proposed capital structure consisted of 40.86 percent debt and 59.14 percent common equity (id.).[216]

b. Short-Term Debt

i. Introduction

As of the end of the test year, NYNEX had $159,422,000 in short-term debt (Exh. AG-464). The Company did not include this in its proposed capital structure (Exh. NYNEX-10, exh. C).

ii. Positions of Parties

(A) Attorney General

The Attorney General advocates that the Company's balance of short-term debt be included in its capital structure. In support

[216] Because the purpose of the capital structure is to determine the weighted average cost of capital, the ratios of the components of capital structure are more important for ratemaking purposes than the dollar amount of the components.

of this, the Attorney General argues that all of the Company's capital sources, regardless of the source, should be used in determining its weighted cost of capital (Attorney General Brief, Part II, at 62). Noting that gas and electric utilities recognize the cost of short-term debt in their calculation of allowance for funds used during construction ("AFUDC"), the Attorney General states that ratepayers of these utilities receive the benefits associated with the lower cost of short-term debt (id. at 62, citing 18 C.F.R. c. 1, Subchapter C, Part 101, at 337, and Subchapter F, Part 201, at 166). On the other hand, the Attorney General contends that NYNEX determines its AFUDC based on the overall weighted cost of capital as determined in its most recent rate case (id. at 62-63, citing Tr. 9, at 127-129). Therefore, the Attorney General concludes that the Company's ratepayers do not receive the benefit of a lower cost of debt (id. at 63).

The Attorney General argues that other jurisdictions in which NYNEX provides local exchange service, including New York and Vermont, include short-term debt in capitalization (id. at 63, citing New York Telephone Company, N.Y.P.S.C. ALJ Opinion Case No. 92-C-0665, at 234, and Commission Order (1993); New England Telephone Company, Docket Nos. 5700/5702 (Vt. Pub. Serv. Bd. 1994)). As a measure of the Company's short-term interest rate, the Attorney General advocates the use of the Company's commercial paper rate of 3.6 percent (Attorney General Reply Brief at sch. 14, citing Exh. AG-464).

(B) NYNEX

NYNEX justifies its exclusion of short-term debt from capital structure as consistent with Department precedent (NYNEX Brief at 134). The Company contends that the Department expressly rejected the inclusion of short-term debt in capitalization because the allowance for short-term funds is included in the calculation of cash working capital (id.; NYNEX Reply Brief at 39-40). The Company characterizes the Attorney General's proposal as belated, a non-issue, and a "patent red herring" (NYNEX Brief at 134).

iii. Analysis and Findings

In D.P.U. 86-33-G, the Department stated that it does not include short-term debt in capital structure and directed the Company to remove its short-term debt from its capital structure. D.P.U. 86-33-G at 380-381. While the Company's exclusion of short-term debt from capital structure is consistent with the directives of the Department, we note that the premise behind exclusion is that short-term funds are associated with construction and thereby accounted for in the AFUDC calculation. Id.; 18 C.F.R. Ch. 1, Subchapter C, Part 1, at 337, and Subchapter F, Part 201, at 166. This premise does not appear to be operative in this case. According to NYNEX, its AFUDC rate is equal to the weighted average cost of capital approved in D.P.U. 86-33-G (Exh. AG-646; Tr. 9, at 127-128). Because the Company's short-term debt was excluded from this calculation, the Department finds that NYNEX does not consider short-term debt in its AFUDC computation. [217]

While NYNEX's treatment of short-term debt for AFUDC purposes appears to be at odds with general utility practice, there is nothing on the record with respect to the Company's actual use of short-term debt in its operations. Based on this record, the Department finds that there is insufficient evidence to support the Attorney General's proposed adjustment.

c. Capital Leases

i. Introduction

Included in the Company's proposed long-term debt is $3,688,447 in capital leases (Exh. DPU-6). NYNEX testified that under the requirements of Financial Accounting Standards ("FAS") 13, capital leases represent long-term loans from lessors, and thus should be incorporated in capital structure (Tr. 10, at 10-11).

ii. Positions of Parties

(A) Attorney General

The Attorney General opposes the inclusion of capital leases

[217] We note that the Company failed to address the merits of the Attorney General's argument on this point.

in NYNEX's capital structure. According to the Attorney General, capitalized leases simply represent the net present value of annual lease costs, discounted at particular rates, and only serve to indicate the existence of long-term financial obligations to the leasing company (Attorney General Brief, Part II, at 65, citing FAS No. 13, ¶¶ 10-14). The Attorney General contends that no cash expense is incurred by such leases (Attorney General Brief, Part II, at 65). Therefore, the Attorney General concludes that the inclusion of these leases in capitalization would allow NYNEX to be compensated for a cost that it does not incur (id. at 64-65).

The Attorney General contends that the FCC's treatment of lease costs is neither authority nor precedent for the Department's ratemaking treatment, and that the Company was unable to cite a single case in which capitalized leases were included in a utility's capital structure (Attorney General Reply Brief at 71). According to the Attorney General, exclusion of these leases from capital structure would not hinder the Company's ability to pay the leases, because lease expenses would still be recoverable as part of O&M expenses (Attorney General Brief, Part II, at 65 n.40; Attorney General Reply Brief at 71).

(B) NYNEX

NYNEX argues that the Attorney General's position reflects a misunderstanding of FCC financial requirements (NYNEX Brief at 137). Prior to January 1, 1988, the Company and its subsidiaries accounted for capital leases by taking the full lease payment as an operating expense (id. at 138). Thereafter, according to NYNEX, the FCC revised the provisions for treatment of capital leases for Class A telephone companies (including NYNEX) so that such companies must determine what part of the capital lease is associated with the depreciable cost of the leased property, and what part of the payments represents implicit interest (id., citing 47 C.F.R. Part 32). Hence, NYNEX contends that only the depreciable portion of the lease payment is recoverable as an operating expense; the interest portion of the lease expense can only be recovered by including the unamortized balance of the lease in the utility's capital structure (id. at 138-139). NYNEX claims that had the Attorney General raised this issue during the hearings, the Company would have been able to explain the accounting treatment of the leases (id. at 139).

The Company maintains that acceptance of the Attorney General's proposal would prevent it from sufficiently recovering its lease expense (id.; NYNEX Reply Brief at 41-42). NYNEX states that the inclusion of its capital leases in its capital structure for Massachusetts ratemaking purposes would be consistent with both FCC accounting regulations and financial accounting standards (NYNEX Reply Brief at 42, citing 47 C.F.R.

Part 32, § 32,2681; Tr. 10, at 10-11).

iii. Analysis and Findings

As we have noted above, FCC accounting requirements do not preempt the Department from requiring different treatment for ratemaking purposes. Louisiana Pub. Serv. Comm'n v. Federal Communications Comm'n, 100 S. Ct. 1890 (1986). The Department has also found that general accounting standards do not necessarily dictate ratemaking treatment. Massachusetts Electric Company, D.P.U. 92-78, at 79 (1992); Bay State Gas Company, D.P.U. 89-81, at 33 (1989); Western Massachusetts Electric Company, D.P.U. 85-270, at 118-119 (1986).

A review of Department precedent indicates that the specific issue of whether to include capitalized leases as part of a utility's capitalization for ratemaking purposes has not been previously addressed. However, the Department has addressed other issues related to leased property, and these cases provide assistance in determining the issue at hand.

Regardless of whether the Company's leases are considered by the FCC or under general accounting standards to be capitalizable, the fact remains that NYNEX does not hold title to the property being leased. A utility's lease expense represents an allowable cost qualified for inclusion in its overall cost of service. Nantucket Electric Company, D.P.U. 88-161/168, at 123-125 (1989). Compare Western Massachusetts Electric

Company, D.P.U. 87-260, at 75 (1988). However, the Department does not permit the inclusion of leased property in rate base. D.P.U. 88-161/168, at 43-46. Consistent with our policy on leased property, the Department finds it inappropriate to include capitalizable leases in the Company's capital structure. Accordingly, the Department shall exclude NYNEX's capitalized leases from its proposed long-term debt balance.

Since January 1, 1988, the Company and other Class A telephone companies have been required to separate interest payments from the depreciable cost of the property being leased. See 47 C.F.R. Part 32. Therefore, the Company's lease expense that is part of operating expenses includes only the portion of the lease payment attributable to the depreciable portion of the property being leased. The Department concurs with the Company that the removal of capitalized leases from capitalization, without a corresponding adjustment to test year lease expense, will result in a shortfall in the Company's recovery of its annual lease expense. The record indicates that the portion of the Company's annual lease payment associated with interest charges is $431,080 (Exh. NYNEX-10, exh. A at 1). Accordingly, the Department shall increase the Company's test year cost of service by $431,080.

d. Equity Investment in TRG

i. Introduction

TRG, which operates and maintains major data processing hardware and systems, provides staff and operational support services to the NYNEX telephone companies, and provides an extensive range of material management services, including purchasing, warehousing, logistics, and technical services, is a wholly-owned subsidiary of NYNEX-New England and New York Telephone (Exh. NYNEX-9, at 19-20). TRG has no outstanding debt of its own; its capitalization is the same as that of the Company (Exh. AG-460). The Company testified that it uses the "equity method" of accounting for TRG, in which earnings from TRG are reflected on the Company's income statement as income, and dividends are recorded as cash received (Tr. 12, at 38-39).[218] The Company records these dividends below-the-line, because NYNEX's investment in TRG is not included in rate base either in Massachusetts or elsewhere (id. at 37). As of the end of the test year, NYNEX's common equity balance included $119,707,157 in equity from TRG (Exh. AG-659, at 4; Tr. 12, at 35).

ii. Positions of Parties

(A) Attorney General

The Attorney General concurs with NECTA that NYNEX's investment in TRG should be eliminated from its capital structure (Attorney General Reply Brief at 71). The Attorney General notes

[218] All of TRG's earnings are paid out as dividends to the Company and NYT (RR-AG-59).

that while the Company claimed its investment in TRG is based on both debt and equity, TRG charges back to NYNEX and NYT a return based on virtually all common equity (id. at 71-72). Thus, the Attorney General concludes that this belies NYNEX's claim that both debt and equity provide the source for its investment in TRG (id.).

(B) NECTA

NECTA challenges the Company's inclusion of its equity investment in TRG as part of its common equity. NECTA reasons that, because TRG is a nonregulated operation, the Company's investment in TRG was funded out of retained earnings (NECTA Brief at 95). Therefore, NECTA advocates the exclusion of $119.7 million from the Company's common equity balance (id.). NECTA points to the Department's treatment of this issue in Colonial Gas Company , D.P.U. 84-94, at 51 (1984), where equity investment in a subsidiary was removed from that utility's capital structure (NECTA Reply Brief at 30-31).

(C) NYNEX

NYNEX contends that while it uses the equity method to determine the value of its investment in TRG, any individual investment is financed through its overall capital structure, including debt and equity capital (NYNEX Brief at 140, citing Tr. 12, at 35-39; Tr. 15, at 17). According to the Company, proof that it does not rely exclusively on equity to finance TRG is demonstrated by the fact that TRG's return on equity is 12.2 percent, or higher than the overall return of 10.6 percent (NYNEX Reply Brief at 43, citing Tr. 12, at 38). The Company further claims that because its proposed capital structure is in line with what was approved in D.P.U. 86-33-G, NECTA's proposed adjustment is unjustified (NYNEX Brief at 140).

iii. Analysis and Findings

The Department initially notes that the mere fact that a utility's proposed capital structure is approximately the same as was approved in its last rate proceeding does not, in and of itself, constitute evidence that the proposed structure is currently valid. Accordingly, the Department will evaluate the proposed adjustment on the basis of the record evidence and Department precedent.

The record indicates that NYNEX's investment in TRG is not included in rate base. Nor are the Company's earnings from TRG included above-the-line. As noted above, notwithstanding these factors, the Company is seeking to include the retained earnings derived from TRG as an element of NYNEX's capital structure. The Department has found previously that inclusion of equity investment of subsidiaries in capital structure would improperly weight the cost of capital by including investment not used in a utility's intrastate operations. Colonial Gas Company, D.P.U. 84-94, at 51 (1984); Boston Edison Company, D.P.U. 18515, at 56-58 (1976). Accordingly, the Company's equity investment in TRG shall be excluded from its proposed capital structure.

2. Cost of Debt

a. Introduction

In its prefiled testimony concerning earnings, NYNEX proposed a 7.50 percent cost rate for long-term debt (Exh. NYNEX-10, exh. A). To determine its proposed cost rate, the Company first determined the annual costs for each debt issue, including interest expense and amortization of issuance costs (Exh. AG-543, Att. 5, Sheet 22, at 1). The sum of the annual debt issue expenses, less $5,709,035 consisting of (1) annual amortization of call premiums, (2) expenses on refunded issues, and (3) Offer to Purchase expenses, was then determined to be $156,424,821 (Exhs. NYNEX-10, exh. A; AG-652). Then the Company determined the total debt component by adding the book value of its outstanding debt instruments, $3,688,447 in capital leases, and a credit of $97,767,429 in unamortized call premiums, premiums/discounts on debt, and issuance costs, for a total debt component of $2,085,921,018 (Exhs. AG-568; AG-651; Tr. 10, at 7). The Company's total annual charges of $156,424,821, divided by total debt of $2,085,921,018, resulted in a composite cost of debt of 7.50 percent (Exh. NYNEX-10, exh. A).

During the hearings and at the request of the Attorney

General, NYNEX calculated the effective cost of its long-term debt using the method prescribed by the Department in Boston Gas Company, D.P.U. 93-60, at 47 (1993) (Exh. DPU-6; RR-AG-76). This method resulted in an embedded cost of debt rate of 7.16 percent (Exh. DPU-6). The Company objected to the use of this method and the resulting cost rate (id.).

b. Positions of Parties

i. Attorney General

The Attorney General contends that by deducting the unamortized balance of its issuance costs from its outstanding debt, NYNEX has improperly increased the cost of debt by effectively including carrying charges on its issuance costs (Attorney General Brief, Part II, at 63, citing Berkshire Gas Company, D.P.U. 90-121, at 159-161 (1990)). The Attorney General maintains that the Department has found that carrying charges on issuance costs are extraordinary non-recurring costs, and that NYNEX has provided no new evidence or argument to support a change in precedent (Attorney General Brief, Part II, at 64, citing Boston Edison Company, D.P.U. 86-71, at 12 (1986)). The Attorney General argues that by eliminating the $97,767,429 deduction from unamortized balances from the Company's capital structure as detailed in Exhibit AG-543, NYNEX's effective cost of debt is decreased to 7.16 percent (Attorney General Brief, Part II, at 64). The Attorney General contends that the Company has no basis on which to claim that telephone companies warrant special treatment on this issue than other utilities, noting that the issue has not been the subject of careful review in previous telephone cases (Attorney General Reply Brief at 70, _citing_ D.P.U. 86-33-G; _AT&T_, D.P.U. 85-137 (1985); _NET_, D.P.U. 411 (1981)).

ii. _NYNEX_

NYNEX contends that the Attorney General's approach, if adopted, would deprive the Company of the ability to recoup its issuance or premium costs. According to NYNEX, whenever bonds are issued at a discount, the net proceeds to the utility are lower than the face value of the bonds (NYNEX Brief at 135). Likewise, issuance costs serve to reduce the net proceeds available to the issuer (_id._). Despite this, the annual interest charge to the utility is based on the entire value of the issue, not just the net proceeds (_id._ at 135-136). Thus, applying the straight coupon rate to the issue would result in a revenue shortfall to the Company, and would fail to meet the fair and reasonable rate of return standard prescribed in _Hope Natural Gas_ (_id._ at 136).

The Company contends that its treatment of unamortized issuance and premium expenses is identical to that used by the Department in D.P.U. 86-33-G (NYNEX Brief at 136, _citing_ Exh. NYNEX-10, exh. A). The Company claims it is not asking for a return on its unamortized issuance costs, but rather a treatment of those costs consistent with that accorded in prior rate cases (NYNEX Reply Brief at 40). The Company claims to have relied on those prior decisions as part of its efforts to refinance its debt at lower costs, and that it is entitled to "reasoned consistency" by the Department (id. at 41).

c. Analysis and Findings

The Department's precedent on the treatment of issuance expenses and call premia in the calculation of the cost of long-term debt is well-established. The Department has ruled consistently that debt issuance costs, including call premia, are extraordinary non-recurring costs because the amount of the expenses and the amount of time between the incurrence of the expenses cannot be normalized. Boston Edison Company , D.P.U. 86-71, at 12 (1986). Therefore, the Department has required that debt issuance costs should be amortized over the life of the issue, without a return on the unamortized balance. Id.; Boston Gas Company , D.P.U. 93-60, at 238-239 (1993); Berkshire Gas Company , D.P.U. 90-121, at 159-161 (1990).

Contrary to NYNEX's assertion that its proposed treatment of unamortized issuance and premium expenses was previously accepted by the Department in D.P.U. 86-33-G, the matter was not litigated in that case because no party contested the Company's cost of debt. D.P.U. 86-33-G at 332. Nor was the issue addressed by the

Department in NET, D.P.U. 411 (1981), or the Company's rate case proceeding D.P.U. 86-33-G. However, the issue has been raised and considered in subsequent Department cases. Boston Gas Company, D.P.U. 93-60, at 238-239 (1993); Cambridge Electric Light Company, D.P.U. 92-250, at 136-137 (1992); Berkshire Gas Company, D.P.U. 90-121, at 159-161 (1990). The Department finds no basis on which to accord NYNEX different ratemaking treatment. Accordingly, the Department shall address the Company's determination of its effective cost of debt.

In this case, NYNEX has asserted that the cost of debt calculated in accordance with the method prescribed in D.P.U. 93-60 fails to allow recovery of issuance expenses and relevant premia. Under the Company's proposed method, the total annual interest charge includes the amortization of issuance costs, discounts and call premiums (Tr. 16, at 46). However, NYNEX's method also involves reducing the book value of its debt issues by the unamortized call premia, premia and discounts, and issuance costs (Exh. AG-568). Thus, through its use of a smaller denominator, the Company would be recovering both its total issuance costs and assorted premia/discounts, and a return on the unamortized balance. As noted above, this is contrary to Department precedent, and the Company has presented no argument that persuades us to change our holding on this issue. Accordingly, the Department finds that the Company has incorrectly calculated its effective cost of long-term debt.

Therefore, the Department denies the Company's proposal relating to the treatment of issuance costs and call premia in the calculation of the cost rate of long-term debt. Based on the information contained in Exhibit DPU-6, the Department finds that the appropriate cost of debt is 7.16 percent.

3. Return on Common Equity

a. Introduction

As part of its earnings filing, NYNEX argued that its current cost of equity is between 13 and 14 percent, and therefore that its currently authorized ROR on common equity of 13 percent is reasonable (Exh. NYNEX-10, at 22-23). In determining its proposed cost of equity, the Company relied on a discounted cash flow ("DCF") analysis, a risk premium analysis, a capital asset pricing model ("CAPM"), and a comparable earnings approach (id. at 23).

The Company applied these methods to three different groups of companies incorporating various risk measures as screening criteria (id.). These groups consisted of: (1) the Local Exchange Company parent ("LEC Parent") group of 13 rated American firms where LEC service accounts for more than 50 percent of revenues; (2) High Grade Universals, consisting of 52 companies included in Value Line with Standard and Poor's ("S&P") debt ratings falling between AAA and AA-; and (3) a Beta[219] group consisting of 96 non-LEC, non-utility, non-financial domestic corporations with Value Line betas ranging between 0.80 and 0.90, or similar to the 0.86 beta reported for the LEC Parent group (id. at 23-24; Exh. NYNEX-10, exh. G). NYNEX further screened its High Grade Universal group to improve its comparability with the LEC Parent group by removing high-beta companies from consideration (Exh. NYNEX-10, at 23, 35). The spread of equity calculations ranged between 12.9 percent using a DCF model and 14.0 percent using a comparable earnings approach (id., at exh. I). Citing the competitive market in telecommunications, the greater degree of business risk, and its doubts as to the applicability of the results of its DCF analysis as noted below, NYNEX concluded that the required return on common equity should be at the high end of the resulting range, for a required return of 14.0 percent (Exh. NYNEX-10, at 37-38).

The Attorney General presented Timothy Newhard, financial analyst for the Attorney General's Regulated Industries Division, who recommended a 10.70 percent return on common equity for NYNEX based on an examination of the seven regional holding companies ("RHCs") created by the 1984 breakup of AT&T (Exh. AG-792, at 27;

[219] Beta measures the systematic risk, i.e., the level of risk that cannot be diversified away in a portfolio of assets. Cambridge Electric Light Company, D.P.U. 92-250, at 153 (1992).

Tr. 21, at 44). His analysis and recommendation is described below.

The alternative methods used by the Company and the Attorney General to measure return on equity are addressed individually below. Here, we address a component common to each of these methods -- the risks faced by NYNEX and their impact on the Company's proposed cost of equity.

b. Relative Risk of Company

i. Introduction

The Company maintains that the investment community currently perceives the telecommunications industry to be either at or moving towards competition in virtually all markets, including the local exchange market (Exh. NYNEX-10, exh. A at 1-2). NYNEX points to recent moves by large interexchange carriers into markets once controlled by the Company, the efforts of cable companies to enter this field, as well as recent moves by other RHCs to operate in territories formerly outside their own regions (Exh. NYNEX-10, at 11, exh. A). Recognizing this move in the industry, the Company notes that the FCC has accelerated its physical collocation policy in order to create new opportunities for provision of access services traditionally provided by LECs (id. at exh. A).

According to NYNEX, the shifting structure of the telecommunications industry demands that the Company be in a position to enter the capital markets frequently and/or whenever customer demands require financing, regardless of the state of the capital market at the time of the required financing (Exh. NYNEX-10, at 9). Under these conditions, the Company claims that it is extremely important that it regain and maintain a strong AA credit rating (id. at 10). This, the Company contends, would allow it maximum flexibility in the capital markets, facilitate the refinancing of high interest debt as the opportunity arises, and permit the most efficient operation at the lowest cost to customers (id.).

ii. Positions of Parties

(A) Attorney General

The Attorney General notes, based on recent rulings, that the Company's proposed cost of common equity is 300 basis points higher than the highest allowed return on common equity for any other jurisdiction in which NYNEX operates (Attorney General Reply Brief at 73, citing New York Telephone, Opinion No. 94-2, at 15 (N.Y.P.S.C. 1994) (cost of equity found to be 10.8 percent); New England Telephone and Telegraph Company, Docket Nos. 5700/5702, at 82 (Vt. Pub. Serv. Bd. 1994) (cost of equity found to be 11.0 percent)).

The Attorney General takes issue with the Company's selection of comparison groups (Attorney General Brief, Part II, at 68-69). He contends that the Company's High Grade Industrial group, based only on comparable debt ratings, fails to assess the business risk of the group (id. at 69). Similarly, the Attorney General maintains that the Company's Beta group fails to consider financial or business risks relative to the Company (id. at 69-70). While the Attorney General notes that the LEC Parent group is more similar to the Company in terms of business risk, he contends that the inclusion of non-RHCs in the group fails to account for regulatory risk associated with the Modified Final Judgment ("MFJ"), and argues that there is no evaluation of the financial risk of the companies included in this group (id. at 70). The Attorney General argues that it is inappropriate to assume, as NYNEX has, that the selection criteria used in the instant case conforms to the standards laid down in D.P.U. 86-33-G (Attorney General Reply Brief at 74).

(B) NECTA

NECTA cites the Company's ability to internally finance construction and that those risk elements it faces are created by its unregulated business activities, including its parent's investment in Viacom and plans to invest in broadband technology (NECTA Brief at 96-97; NECTA Reply Brief at 38). NECTA maintains that the Company's risks are also exacerbated by its "chronic" misallocation of costs to intrastate regulated operations, and lack of a dividend reinvestment program or employee stock ownership plans (NECTA Brief at 97). Therefore, NECTA urges the

Department to set NYNEX's return on common equity at the lowest end of a reasonable range (id.; NECTA Reply Brief at 38-39).

(C) NYNEX

According to the Company, it has properly considered a broad range of companies and appropriate subgroups based on risk parameters similar to those of NYNEX, and thus complies with the directives of the Department in D.P.U. 86-33-G (NYNEX Brief at 143). NYNEX notes the range of regulated and nonregulated companies included in its analysis, stating that its selected criteria recognizes the alternative investment opportunities open to investors, given particular levels of risk (id. at 143-144). The Company maintains that this variated comparison group meets the "corresponding risk" criteria expressed in the Hope Natural Gas decision (id. at 144, citing Federal Power Comm'n v. Hope Natural Gas Co. , 320 U.S. 591, 603 (1944)).

iii. Analysis and Findings

In determining an appropriate group of companies to use as a comparison, the Department has found that it is not necessary to find utilities identical to the utility being analyzed. Just as overly-broad criteria will weaken the validity of the results of the analysis, overly-restrictive criteria could result in a comparison group that is so small as to be unreliable. In recognizing this, the Department has required companies to use valid criteria to choose its comparison group and to provide sufficient financial and operating data to allow the Department to review any differences between the investment risks of the comparison group and the subject company. Cambridge Electric Light Company, D.P.U. 92-250, at 141 (1992); Essex County Gas Company, D.P.U. 87-59, at 68 (1987).

NYNEX's High Grade Industrial Group was selected based on their respective bond ratings, with further refinement made for beta as part of the DCF analysis. Similarly, NYNEX's selection criteria for its Beta group was based on a range of beta values. For the reasons stated below, the Department finds that the Company's High Grade Industrial and Beta comparison groups exhibit little comparability to that of NYNEX. Accordingly, the Department shall place little weight on the Company's cost of common equity analyses that rely on either of these groups as a basis for comparison. We agree with the Attorney General in that, while the Company's LEC Parent group is more similar to the Company in terms of business risk, the inclusion of non-RHCs adds an element of complication to the analysis through the restrictions placed on RHCs pursuant to the MFJ. Accordingly, the Department shall consider the comparability of the LEC Parent Group in light of the record evidence in this case and the implications of the MFJ on the Group's operations.

c. Discounted Cash Flow Analysis

i. Introduction

The DCF model postulates that the value of an asset is equal to the present value of future expected cash flows discounted at the appropriate risk-adjusted rate of return (Exh. NYNEX-10, at 28). In its simplest form, the risk-adjusted rate of return on common stocks derived from a DCF analysis includes two components: (1) the anticipated cash dividend yield; and (2) the future growth appreciation of the investment (id. at 27-28).

NYNEX used the following equation to model its DCF analysis:

Expected Return on
Common Equity $K = (D1 / P0) + g$

where K is the investor's required cost of capital, D1 is the anticipated dividend, P0 is the stock price, and g is the expected growth rate (id. at 28).

As a basis for determining the yield component of its DCF analysis, the Company examined stock prices for its High Grade Industrial and Beta groups for the six-month period ending June 1994 (id. at 30, 34). To improve the comparability of its High Grade Industrial group, NYNEX eliminated all high beta companies from its analysis, thus reducing the High Grade Industrial group from 64 to 30 with a beta similar to that of the LEC Parent group (id. at 35; Exh. AG-762). For the purposes of its DCF analysis, NYNEX adjusted the dividend yield to take into consideration one-half of the expected growth rate, thereby assuming that companies will declare an increased dividend mid-way through the coming year (Exh. NYNEX-10, at 30).

NYNEX noted that the existence of flotation costs (i.e., costs incurred in issuing new securities) means that the proceeds of a new stock issue are less than the market price of the stock (id. at 28). According to the Company, failure to recognize issuance costs and market pressure (i.e., a decline in price associated with the sudden increase in supply of a particular security on the market) would produce a negative growth in the Company's book value (id. at 28-29). In what the Company considered to be a conservative adjustment, NYNEX increased the dividend yield by a combined 5 percent factor to account for both issuance costs and market pressure (id. at 29).

To determine the growth rate component of its DCF analysis, the Company relied on the consensus forecast provided by the Institutional Brokers Estimate System ("IBES") (id. at 31). The IBES data include analyses and forecasts of the earnings per share for over 3,400 different companies which are used extensively by institutional investors, and for which extensive research has been performed on the quality and use of the forecasts relative to investment decisions (id.). The Company states that the IBES data provide the most reliable estimate of the future expected growth rate for a security (id.). Using the IBES data, NYNEX determined that the dividend growth rate for the reduced High Grade Industrial group was 10.1 percent (id., exh. G at 2). The corresponding results for the Beta group was a dividend yield of 11.5 percent (id., exh. G at 3-4).

Based on this analysis, the Company concluded that the equity return using the DCF analysis for the reduced High Grade Industrial group was 13.49 percent (id. at 35). The corresponding results using the Beta group was a required return of 12.96 percent (id.).

The Company also performed a DCF analysis of its LEC Parent group, primarily as a check on the reliability of its DCF analyses (id. at 34). Using the same analysis described above, NYNEX determined that the required return on equity for the LEC Parent group using a DCF analysis was 12.30 percent (id. at exh. G at 5). However, the Company cautioned against placing great reliance on the results of the LEC Parent Group DCF analysis (id. at 32, 35). NYNEX claimed that the market expectations of the RHCs included the prospects for greater returns in the cellular industry, substantial earnings contributions from nonregulated and foreign enterprises, long-term earnings growth through the possible lifting of some or all of the MFJ and cable television cross-ownership restrictions, and the likelihood of greater earnings from incentive regulation, increased productivity, and new technologies (id. at 32-33). According to the Company, these changes are not sufficiently accounted for in the DCF analysis (id. at 33-34).

In its rebuttal testimony, the Company sought to analyze the Attorney General's two-stage DCF analysis with the intent of demonstrating that even his own data and analysis supported NYNEX's proposal (Exh. NYNEX-36, at 23-24). NYNEX determined that based on the Attorney General's projected retained earnings growth rates from Value Line as provided in Exhibit AG-792, Schedule 5, the Company's growth expectations ranged between 6.5 percent and 7.50 percent (id. at 6). The Company rejected the use of historical growth rates, claiming that past performance was not indicative of future activity, and that the use of historical data would double-count the consideration given it by financial analysts in their own projections (id. at 6-7).

To determine the yield, the Company examined the most recent six months of data found in Exhibit AG-792, Schedule 4, and concluded that an appropriate yield component was 5.13 percent (id. at 8-9). NYNEX adjusted the yield to reflect its contention that, contrary to the Attorney General's argument, nonregulated operations posed less risk to the Company than its regulated operations (id. at 11). Based on the stock price changes associated with the spinoff of Pacific Telesis' cellular operations and AT&T's announced purchase of McCaw Communications, the Company estimated that NYNEX's own cellular operations contributed between $8.00 and $11.00 of value to its then-current market price of $38.00 per share (id. at 11-12). According to the Company, the exclusion of cellular operations from the Attorney General's RHC comparison group thus increased the apparent dividend yield from 5.13 percent to 6.73 percent (id. at 13). The Company further adjusted the yield to reflect anticipated dividend increases during the upcoming year and the 0.42 percent growth associated with new stock issuances, thus resulting in a required return on common equity of between 13.88 and 14.92 percent (id., exh. 3). Thus, NYNEX concluded that even under the Attorney General's analysis, a return on equity of 14.0 percent was justified (Exh. NYNEX-36, at 24).

To further buttress its arguments, the Company performed a three-stage DCF analysis on its LEC Parent group and the Attorney General's RHC group (id., Sch. 2). NYNEX relied on a consensus of earnings and dividend growth rates from various analysts for the first five-year stage, a blended growth rate modified by specific company assessments for the next ten-year stage, and a sustainable earnings growth rate for subsequent years (Exh. NYNEX-36, at 19). NYNEX concluded that the appropriate return on equity for the LEC Parent group was 13.5 percent, and 13.1 percent for the RHC group (id. at 19, Sch. 2).

ii. Positions of Parties

(A) Attorney General

The Attorney General criticizes NYNEX's selected dividend yield and growth rate, as well as the Company's adjustment for issuance costs. He first argues that the Company has inappropriately discounted the effect of twelve-month data in the calculation of the yield, noting that many financial publications report the twelve-month high-low stock price along with the most recent one (Attorney General Brief, Part II, at 74). The Attorney General advocates using the average of the six-month and twelve-month average dividend yields to determine the appropriate dividend yield component of the DCF analysis, adjusted by an increase of about one-half the expected DCF growth rate in order to reflect the anticipated dividend for the next quarter (id.).

Second, the Attorney General attacks NYNEX's adjustment for issuance costs and market pressure. He contends that because these costs are already considered by investors when they determine the price that they are willing to pay for a company's stock, a further adjustment for these factors overstates the investor's required return on equity (id. at 85-86). The Attorney General argues that the Department has previously rejected such adjustments for issuance costs in previous cases, including D.P.U. 86-33-G (id. at 86). The Attorney General goes on to note that, with the existence of dividend reinvestment and employee stock ownership programs, the Company's issuance costs for substantial amounts of its stock issues are minimal (id.).

Third, the Attorney General criticizes the Company's use of IBES' consensus five-year forecast of earnings per share as a proxy for the growth component. He contends that the short-run variation in the rate of growth noted in the IBES data renders the Company's earnings per share data inappropriate for measuring the DCF growth rate (id. at 76). In support of this, the Attorney General points to the extreme range of results generated by DCF analysis of NYNEX's High Grade Industrial group, which he contends demonstrates the unrepresentative results attained from the IBES data (id. at 76-77). He further points to the Company's own acknowledgement of the limitations present in the IBES data (id. at 77, citing Exh. NYNEX-10, at 32-34).

The Attorney General observes that there are many proxies available to determine investor expectations of the DCF growth rate. He contends that these proxies, used by themselves, can provide inaccurate measures of investor growth expectation (Attorney General Brief, Part II, at 75). According to the Attorney General, the retained earnings growth rate is the best proxy to use for the expected DCF growth rate, because it balances the effects of dividends per share and earnings per share (id. at 75-76). The Attorney General points to the Department's acceptance of the retained earnings growth rate as a proxy for the DCF growth rate in previous cases (Attorney General Reply Brief at 76, citing Western Massachusetts Electric Company , D.P.U. 84-25, at 163 (1984); Boston Edison Company , D.P.U. 1720, at 104 (1983)).

(B) NYNEX

The Company defends its use of IBES data to derive its growth estimate, noting that the Department has previously accepted the substantial weight accorded to IBES data in determining the appropriate growth rate (NYNEX Brief at 148, citing D.P.U. 86-33-G at 355-356). Regarding the choice of dividend yield, NYNEX states that the Department had endorsed in D.P.U. 86-33-G two methods of recognizing the time value to investors of dividends paid quarterly throughout the year, and that it has selected a more conservative approach that does not reflect compounded dividend payments (NYNEX Brief at 158).

iii. Analysis and Findings

In the past, the Department has addressed DCF analysis as a basis for determining the appropriate rate of return on equity. Boston Gas Company, D.P.U. 93-60, at 250 (1993); Cambridge Electric Light Company, D.P.U. 92-250, at 146 (1992); Bay State Gas Company, D.P.U. 92-111, at 257 (1992). As indicated supra, the Company's proposed DCF model assumes that the value of an asset is equal to the present value of future expected cash flows discounted at the appropriate risk-adjusted rate of return. Because the dividend yield and growth rate components of this risk-adjusted rate of return are variables that reflect investor expectations on future performance of stock investments, there will always be potential problems and limitations in estimating the appropriate values of these two variables.

Regarding the dividend yield component of the DCF, the Department has previously rejected those adjustments that tend to overstate the dividend yield component and consequently the DCF-based cost of equity. More specifically, the Department has rejected financial and market adjustments and those adjustments that could double-count the effect of the growth rate factor. See Boston Gas Company, D.P.U. 93-60, at 250 (1993); Cambridge Electric Light Company, D.P.U. 92-250, at 146 (1993); Western Massachusetts Electric Company, D.P.U. 85-270, at 232-233 (1986). The Department has previously accepted the use of six-month data when necessary to recognize more current market experience. Massachusetts Electric Company, D.P.U. 92-78, at 112 (1992). In view of the change in Pacific Telesis' stock price resulting from its spinoff of cellular operations, the Department finds that greater weight should be accorded to the more recent stock history of the LECs. The Department further finds, based on this record, that the Company had demonstrated the propriety of adjusting its dividend yield to reflect anticipated dividend growth as reflected in D.P.U. 86-33-G at 357-359. However, the Department finds that the Company has improperly adjusted its dividend yield for issuance costs and market pressure. Massachusetts Electric Company, D.P.U. 92-78, at 91 (1992); Berkshire Gas Company, D.P.U. 90-121, at 180 (1990); Boston Gas

Company, D.P.U. 88-67, Phase I at 193 (1988). Because the yield component of the Company's three-stage DCF analysis was based on the same analysis as was used for its single-stage DCF analysis, the Department finds that NYNEX's three-stage DCF analysis also tends to overstate the required cost of common equity.

Concerning the Company's rebuttal testimony on the effect of an LEC's nonregulated activities versus their regulated operations, the Department finds little evidence to support the Company's proposed dividend yield. First, NYNEX failed to demonstrate the nexus between the spinoff of Pacific Telesis' cellular operations and the AT&T-McCaw agreement, and their effect on stock prices. Moreover, the Company's adjustment to the stock price failed to account for any resulting changes in earnings that would have been associated with cellular operations, but would no longer be received by the Company after a spinoff of such operations. NYNEX's asymmetrical adjustment thus overstates the impact of cellular operations on the dividend yield. Accordingly, the Department places no weight on NYNEX's analysis of cellular operations and their impact on LECs.

With respect to the Company's growth rate, the Department has noted that the IBES data represents a conceptually appropriate measure of dividend growth rates. Massachusetts Electric Company, D.P.U. 92-78, at 114 (1992); Western Massachusetts Electric Company, D.P.U. 88-250, at 97 (1989); NET, D.P.U. 86-33-G at 355-356 (1989). Notwithstanding its value in measuring growth rates, we recognize that IBES data do have certain limitations that must be considered in an evaluation of a company's required return on common equity. D.P.U. 86-33-G at 355-356. Regarding the Attorney General's proposed use of the retained earnings growth rate as a measure of dividend growth, the Department has previously found that this method does not necessarily capture the full growth potential of a company. Cambridge Electric Light Company, D.P.U. 92-250, at 147 (1992); Berkshire Gas Company, D.P.U. 90-121, at 180 (1990).[220] Accordingly, the Department shall consider other growth components derived in this proceeding in order to establish an appropriate return on common equity.

d. Risk Premium Analysis/Capital Asset Pricing Model

i. Introduction

The risk premium analysis postulates that the cost of equity for a particular stock is equal to the rate of return for a risk-free investment plus a risk premium sufficient to compensate investors for the added risk of that particular investment (Exh. NYNEX-10, at 24). Similarly, the CAPM approach postulates that the cost of equity for a particular stock is equal to the

[220] We address the merits of the Attorney General's sustained earnings growth rate analysis in further depth below.

rate of return for a risk-free investment plus a risk premium that recognizes the risk for the stock relative to the overall risk of the market (id. at 26). To compute the cost of equity using the CAPM, three components are necessary: (1) the risk-free rate of return; (2) the beta, which measures the systematic risk or level of risk that could not be diversified in a portfolio of assets; and (3) the market risk premium (id.).

To determine its required return on common equity using a risk premium/CAPM approach, NYNEX developed two basic analyses; i.e., a Comparable Group DCF Risk Premium method and the Ibbotson-Sinquefield Risk Premium/CAPM method (id.). A third CAPM method was developed with a Capital Market Line approach for Value Line companies (id.).

NYNEX used the following equation to model its risk premium analysis using the Comparable Group DCF Risk Premium method:

Expected Return on
Common Equity $K = Rf_p + (R_{DCF}-Rf_h)$

where K is the investor's required cost of capital, Rf_p is the prospective return for risk-free securities, R_{DCF} is the historical DCF-derived market return and Rf_h represents the historical return for risk-free securities (id., exh. D).

NYNEX used the following equation to model its CAPM analysis using the Ibbotson-Sinquefield Risk Premium/CAPM approach:

Expected Return on

Common Equity $K = Rf + b(Rm-Rf)$

where K is the investor's required cost of capital, Rf is the return on risk-free investments, b is the beta for the security being analyzed, and Rm is the return in the market (id., exh. E).

NYNEX used the following equation to model its Capital Market Line analysis:

Expected Return on
Common Equity $Y = A + B(x)$

where Y is the investor's required cost of capital, A is the intercept point of the slope, B is the slope, and x is the beta (id., exh. F).

To determine a risk-free rate for its Comparable Group DCF Risk Premium and Ibbotson-Sinquefield Risk Premium/CAPM analyses, the Company used the average yield for long-term government bonds for the six months ending June 1994 (id. at 24). The Company concluded that the most representative risk-free rate of return for use in its analyses was 6.96 percent (id.).

To determine its risk premium under the Comparable Group DCF Risk Premium approach, the Company first performed a DCF analysis for each of the selected Value Line companies for each of the years from 1989 through 1993 to develop expected returns on equity for those companies (id. at 25; Exh. AG-759). Then the Company subtracted from each of the expected returns by year the

30-year Treasury bond rate for that year, thus producing a risk premium (Exh. NYNEX-10, exh. D). The five-year average risk premium was 7.43 percent (id.). Adding this risk premium to the 6.96 percent risk-free rate determined above, the Company concluded that the required return on common equity was 14.39 percent (Exh. NYNEX-10, at 25).

In its Ibbotson-Sinquefield Risk Premium/CAPM approach, the Company first relied on the S&P Composite Stock Index for the period 1926 through 1993 to determine that the appropriate risk/return premium for the same period relative to long-term government bond average income returns was 7.2 percent (id. at 26). NYNEX then measured the beta for its LEC Parents, and found it to be 0.86 (Exh. NYNEX-10, exh. E). Using the risk-free rate for long-term government bonds of 6.96 percent, a beta of 0.86, and a market risk premium of 7.2 percent, NYNEX concluded that the appropriate return on common equity under its Ibbotson-Sinquefield Risk Premium/CAPM approach was 13.15 percent (id.).

Finally, the Company performed a Capital Line Market analysis. This was developed by first determining through a DCF analysis the expected return for each of the 919 companies reported in Value Line that paid dividends and for which data was available (Exh. NYNEX-10, at 26-27, exh. F). This return was regressed against the respective Value Line beta for each company, which produced a line representing the risk/reward expectation of the market under the CAPM concept (Exh. NYNEX-10, at 27). NYNEX then assumed that its LEC Parent group was competitive with the rest of the market, and used the LEC Parent beta to develop the comparable return for that group (id.). The results of this analysis indicated a required return on common equity of 12.84 percent (id. at 27, exh. F).

ii. Positions of Parties

(A) Attorney General

The Attorney General urges the Department to reject the Company's Ibbotson-Sinquefield Risk Premium/CAPM analysis because of its reliance on unrealistic assumptions and its poor application in the instant case (Attorney General Brief, Part II, at 78-79). He maintains that several of the Company's underlying assumptions do not hold true for the application of the model in the case of an investment in NYNEX's comparison group's stock (id. at 80). According to the Attorney General, the Department has rejected the following assumptions inherent in CAPM analysis: (1) investors can borrow and lend unlimited funds at risk-free rates; (2) investors rely on mathematical evaluation of alternative investment returns in their own investment decisions; (3) there are no income taxes; and (4) a 100 percent liquidating dividend is paid at the end of the investment period (id. at 81, citing Commonwealth Electric Company , D.P.U. 956, at 54-55

(1982)). While certain of these assumptions would be highly desirable on the part of investors, the Attorney General argues that none of them hold true in the real world, and that NYNEX never attempted to address these concerns (Attorney General Brief, Part II, at 81).

Further, the Attorney General argues that the Company's application of CAPM theory is fundamentally flawed in each of the parameters chosen for the CAPM analysis. First, he contends that NYNEX's reliance on the Ibbotson Study has never been found by the Department to reflect current investor expectations, particularly with respect to recent changes in inflation and the bond market (id. at 82-83).

Second, the Attorney General argues that the beta has limited applicability. He contends that the beta used by NYNEX, derived from Value Line data, describes very little of the variation in the price of an individual stock (id. at 84). The Attorney General notes that the Department has recognized this weakness, finding that the beta is of little value for purposes of determining the required cost of equity (id., citing Boston Gas Company, D.P.U. 93-60, at 257 (1993); Cambridge Electric Light Company, D.P.U. 92-250, at 158 (1993); Colonial Gas Company, D.P.U. 84-94, at 63-64 (1984); Berkshire Gas Company, D.P.U. 1490, at 74-75 (1983)). He maintains that because the Company failed to provide any new evidence on this issue, the

Department should adhere to its precedent (Attorney General Brief, Part II, at 84).

Third, the Attorney General holds that NYNEX's reliance on long-term Treasury bonds as a proxy for the risk-free rate overstates the actual risk-free cost rate, because long-term Treasury bonds incorporate a measure of maturity risk (id.). He maintains that the correct proxy to use for the risk-free rate is U.S. Treasury bills, which do not have the maturity risk component of Treasury bonds (id. at 84-85).

The Attorney General attacks NYNEX's Comparable Group DCF Risk Premium analysis for its reliance on IBES data. He contends that, for the reasons he criticizes the use of the IBES five-year earning per share growth rate in his analysis of the Company's DCF analysis, the IBES data do not provide a realistic indicator of long-run investor expectations (id. at 83). Therefore, the Attorney General urges the Department to reject this approach as well (id. at 83-84).

(B) NYNEX

NYNEX considers its risk premium analyses to be secondary methods that support the conclusions of its DCF analysis (NYNEX Brief at 161). The Company maintains that its choice of long-term government bonds represents the appropriate risk-free vehicle, because investors are committed to the market for the long term (id. at 162). NYNEX contends that the increase in interest rates has correspondingly increased the yield on long-term bonds, thus providing a degree of conservatism in its risk premium analyses (id.).

The Company describes its Comparable Group DCF Risk Premium and Ibbotson-Sinquefield analyses to demonstrate their validity (id. at 163-164). In its Comparable Group DCF Risk Premium analysis, NYNEX performs a DCF analysis for each of those Value Line companies with betas similar to its LEC Parent group and subtracts from each of the expected returns by year the 30-year Treasury bond rate for that year, thus producing a risk premium of 7.43 percent (id. at 163). This risk premium, added to the 6.96 percent risk-free rate, produces a required return on common equity of 14.39 percent (id.). In its Ibbotson-Sinquefield Risk Premium/CAPM approach, the Company calculates that the appropriate risk/return premium relative to long-term government bond average income returns was 7.2 percent (id.). Adjusting this return for the beta of 0.86, the Company determines that the risk-adjusted average risk premium was 6.19 percent (id.). Using the risk-free rate for long-term government bonds derived above of 6.96 percent and adjusted risk premium of 6.19 percent, NYNEX argues that the appropriate return on common equity under its Ibbotson-Sinquefield Risk Premium/CAPM approach is 13.15 percent (id.). Finally, the Company notes that in its Capital Line Market analysis, its regression analysis demonstrates that its required return on common equity is 12.84 percent (id. at 164).

iii. Analysis and Findings

The record in this case demonstrates that the Company's Ibbotson-Sinquefield Risk Premium/CAPM Comparable Group DCF Risk Premium analyses are intended to serve as supplemental methods to determine NYNEX's proposed cost of equity. With respect to the Company's selection of a risk-free rate, the Department is not persuaded by the definition and data used to evaluate this rate, because a maturity premia is incorporated in long-term government bonds. Thus, the Company's measure of the risk-free rate could overstate the cost of equity based on either the Ibbotson-Sinquefield Risk Premium/CAPM or Comparable Group DCF Risk Premium analyses. Cambridge Electric Light Company , D.P.U. 92-250, at 158 (1992).

With respect to the risk premium measurement found in the Ibbotson-Sinquefield Risk Premium/CAPM approach, the Department in the past has rejected the use of the CAPM as a basis for determining a utility's cost of equity, noting that CAPM has a number of strong assumptions that affect the resulting estimate of the cost of equity. Boston Gas Company , D.P.U. 88-67, Phase I, at 184 (1988). Furthermore, because the coefficients of determination of the betas are relatively low, we cannot place much weight on the statistical reliability of the results of the cost of equity analysis. Berkshire Gas Company , D.P.U. 92-210, at 149-50 (1993). Accordingly, the Department gives no weight to the results of the Company's Ibbotson-Sinquefield Risk Premium/CAPM analysis.

Turning to the risk premium measurement in the Comparable Group DCF Risk Premium analysis, the Department finds that NYNEX has failed to demonstrate its comparability to the companies found in Value Line. The Company's analysis is further undermined by the DCF analysis used to measure the risk premium. To the extent that the Company's DCF analysis above was found to have limitations, the same limitations would apply to the Comparable Group DCF Risk Premium approach. Accordingly, the Department gives no weight to the results of the Company's Comparable Group DCF Risk Premium analysis.

The Department also has evaluated the Company's Capital Line Market analysis. Because of its reliance on data from Value Line companies and its use of beta, whose limitations have been noted above, the Department places no weight on the results of the Company's analysis using this method.

e. Comparable Earnings

i. Introduction

As a check on the results of its other analyses, NYNEX presented a comparable earnings analysis (Exh. NYNEX-10, at 35). The comparable earnings analysis relies on a set of parameters that represent similar risk characteristics of the company being examined and a group of companies that are not public utilities.

To implement the comparable earnings approach, the Company examined its LEC, High Grade Industrial, and Beta groups (id.). Because of its belief that a strong "AA" rating was desirable for the Company, NYNEX eliminated from its High Grade Industrial group the 12 "AAA" rated companies (id. at 36). The historical median five-year returns on book equity under this analysis was 12.46 percent for the Beta group, 13.41 percent for the LEC Parent group, and 16.07 percent for the revised High Grade Industrial group (id., exh. H).

ii. Positions of Parties

(A) Attorney General

The Attorney General urges the Department to reject NYNEX's comparable earnings analysis, arguing that this approach has been repeatedly rejected by the Department as unreliable (Attorney General Brief, Part II, at 86-87). According to the Attorney General, the comparable earnings approach fails to demonstrate that earned returns on common equity equate to the Company's required cost of capital (id. at 87). He asserts that because NYNEX has failed to provide any reasons for the Department to change its precedent, the proposed comparable earnings approach presented in this case should be rejected (id.).

(B) NYNEX

NYNEX argues that its comparable earnings test was done as a final check on the validity of its other cost of equity models (NYNEX Brief at 164). The Company maintains that it properly examined book earnings of its comparison group, reflecting that regulated utility returns are based on book, instead of market, value (id.). NYNEX further argues that it has refined its comparison group by eliminating AAA-rated companies from its analysis (id.). The Company concludes that the historical earned returns on equity for its comparison groups demonstrate the reasonableness of its proposed cost of common equity (id. at 165).

iii. Analysis and Findings

While the comparable group of companies used in the comparable earnings approach are nonregulated firms, the Company has not demonstrated that the firms included in the comparable group have risk characteristics similar to those of NYNEX. In order to meet the comparability criteria spelled out by the United States Supreme Court in Bluefield Water Works and Improvement Co. v. Public Serv. Comm`n of West Virginia , 262 U.S. 679 (1923) and Federal Power Comm`n v. Hope Natural Gas Co. , 320 U.S. 591 (1944), other investment risk criteria must be carefully evaluated as bases for selecting a comparable group of companies. While NYNEX's High Grade Industrial Group may fall within the investment risk criteria used in the analysis, the Attorney General has correctly pointed out the Company's failure to consider other relevant investment risk indicators. Furthermore, the Department notes that the investment risk criteria selected by NYNEX may not represent the most valid criteria. For example, we note that the use of beta as a criterion in selecting the Beta group of comparable companies is not a reliable investment risk indicator given the statistical measurement limitations of beta. Cambridge Electric Light Company, D.P.U. 92-250, at 157-158 (1992); Massachusetts Electric Company, D.P.U. 92-78, at 113 (1992). Accordingly, the Department rejects the Company's comparable earnings approach as a basis for determining NYNEX's cost of equity in this case.

f. Attorney General's Testimony

i. Introduction

As noted, the Attorney General proposed a return on common equity of 10.7 percent (Exh. AG-792, at 27; Tr. 21, at 44). In support of this recommendation, the Attorney General performed a DCF analysis on a group of companies that he perceived as having comparable investment risk to NYNEX (Exh. AG-792, at 6).

The Attorney General's comparison group consisted of the seven RHCs created as a result of the breakup of AT&T (id. at 6-7). Because these companies are still substantially under the restrictions of the terms of the MFJ, the Attorney General perceived their risks as unique in the marketplace (id. at 7; Tr. 21, at 50-51).

The Attorney General used the following equation to model his DCF analysis:

Expected Return on Common Equity	K = (D/P) + g

where K is the investor's required cost of capital, D is the anticipated dividend, P is the stock price, and g is the expected growth rate (Exh. AG-792, at 9).

As a basis for determining the yield component of his DCF analysis, the Attorney General averaged the monthly high and low stock price for each company in his comparison group for the past twelve months to arrive at an average stock price for a given month, and divided the result into the current quarter's annualized dividend (id. at 11). The most recent six-month and twelve-month dividend yields were averaged together to arrive at an estimate for the indicated dividend yield (id.). According to the Attorney General, this approach avoids the day-to-day aberrations inherent in one-day spot stock prices, while taking into consideration historical performance (id. at 10). For the purposes of his analysis, the Attorney General adjusted the dividend yield to take into consideration one-half of the expected growth rate, thereby assuming that companies will declare an increased dividend mid-way through the coming year (id. at 12). Based on this analysis, he concluded that the appropriate yield component of the DCF analysis was 4.97 percent (id., Sch. 4).

In selecting the growth rate component of his DCF analysis, the Attorney General considered and rejected both growth in dividends and growth in earnings. He explained that a dividend growth rate was not totally reliable for long-term purposes, because changes in the payout ratio could lead to an incorrect estimate (Exh. AG-792, at 13; Tr. 21, at 54-55). Similarly, the Attorney General rejected the earnings growth rate approach because of its short-run instability (Exh. AG-792, at 14). To determine the appropriate growth rate, he used the sustainable earnings growth rate (id. at 18).

The Attorney General used the following equation to model his retained earnings growth rate:

Sustainable Earning Growth Rate: $g = (b \times r) + (s \times v)$

where g is the sustainable earnings growth rate, b is the earnings retention rate, r is the return on common equity, s is the growth in the amount of common stock, and v is one minus the book to market ratio of common stock (id. at 17).

Having selected his growth rate method, the Attorney General relied on the average historical and forecasted five-year retained earnings growth rate, and found that the unadjusted retained earnings growth rate (b x r) ranged from 3.93 percent to

7.50 percent (id. at 18). He selected the midpoint of this range, 5.72 percent, for the first part of his sustainable growth estimate (id.).

To determine the value for the (s x v) component, the Attorney General considered Value Line information and projections, and determined that the average growth in new stock issuances was 0.42 percent (id. at 18-19, Sch. 6; Tr. 21, at 43). Thus, the Attorney General concluded that the appropriate sustainable growth rate was 6.14 percent (5.72 plus 0.42) (Exh. AG-792, at 19; Tr. 21, at 43). The Attorney General considered this result to be reasonable in light of the growth rates reported by Value Line for dividends, earnings, and book value per share (Exh. AG-792, at 19-20). Therefore, he concluded that the cost of equity using this DCF approach was 11.26 percent (id. at 20; Tr. 21, at 44).

In addition to this approach, the Attorney General conducted a two-step DCF analysis. This method attempted to address concerns expressed in prior Department orders regarding the reliability of the sustainable growth rate (Tr. 21, at 58). Under a two-step DCF analysis, the assumption is made that there is some near-term growth rate expected by investors based on commonly-available data, after which a different, long-run growth rate is expected (Exh. AG-792, at 20). The Attorney General first determined from five-year earnings growth rate data provided in Standard and Poor's Earnings Guide that the average projected earnings growth rate was 6.46 percent (id. at 21). To determine his long-run growth rate, he assumed that a firm as large as NYNEX could not be expected to outperform the economy in the long-term, and concluded that the long-run growth rate for the Company was between 5.0 and 6.0 percent (id. at 22). Using an iterative process, the Attorney General concluded that the cost of common equity under the two-step DCF approach was between 10.39 percent and 11.21 percent (id. at 22, App. C).

The range of results from the Attorney General's single- and two-step DCF analyses fell between 10.39 percent and 11.26 percent (Exh. AG-792, at 24; Tr. 21, at 44). He proposed a further adjustment to this range to reflect the relative risk associated with the Company's nonregulated operations. The Attorney General reasoned that the RHCs have many nonregulated operations that possess greater business risk than the regulated portions of their operations (Exh. AG-792, at 24-25). Using what he considered to be a reasonable cost of equity for the nonregulated operations of 12.0 percent, the Attorney General further assumed that a 10 percent weight factor should be ascribed to the nonregulated operations (id. at 25-26). After adjusting for nonregulated operations risk, the Attorney General concluded that the adjusted cost of common equity under the two-step DCF analysis was between 10.21 percent and 11.18 percent (id. at 26; Tr. 21, at 44).

As a further check on the relative risk of nonregulated operations on RHCs, and to rebut the Company's contentions that the required return for cellular operations was identical to regulated activities, the Attorney General performed a CAPM analysis using the Company's methods (Exh. AG-815, at 4). He first selected three companies identified by Value Line as providing cellular service (id. at 4-5, Att. 2). Based on their financial statistics, he concluded that these companies represented a greater investment risk than did the RHCs (Exh. AG-815, at 5). Using the risk-free rate for long-term government bonds of 6.96 percent and market risk premium of 7.2 percent, as derived in the Company's own CAPM analysis, the Attorney General factored in his selected beta of 1.5 and concluded that the appropriate return on common equity for cellular operations was 17.76 percent (id. at 6).

ii. Positions of Parties

(A) Attorney General

The Attorney General disagrees with the Company's criticisms of Mr. Newhard's qualifications, and describes as extensive his knowledge of the Department's rate-of-return cases for the past 13 years (Attorney General Reply Brief at 72).[221] He claims the

[221] The Attorney General also points out that Mr. Newhard has performed more cost of equity analyses for a much larger (continued...)

Company's efforts to discredit Mr. Newhard on that basis are unpersuasive (id. at 72-73). He also observes that the Department has found Mr. Newhard's previous testimony in other telephone cases to be more reliable than that of company witnesses (id., citing AT&T, D.P.U. 85-137, at 108 (1985)). The Attorney General argues that the Department's criticisms of Mr. Newhard's analysis in D.P.U. 86-33-G went to the growth rate used in his two-stage DCF analysis, which the Attorney General contrasts with what he considers to be substantial unchallenged evidence presented in this case (Attorney General Reply Brief at 73). The Attorney General maintains that his selection of RHCs for a comparison group offers a more comparable basis to the Company in terms of financial and business risk, and the results of the analysis of this group should be used as the basis for determining NYNEX's return on equity (Attorney General Brief, Part II, at 70).

The Attorney General defends the use of six- and twelve-month average yields, as more reflective of the range of stock prices investors examine in their investment decisions (Attorney General Reply Brief at 78). According to the Attorney General, it is appropriate to average the six- and twelve-month

[221] (...continued) variety of regulated utilities during his employment with the Attorney General than the Company's own witness has done (Attorney General Reply Brief at 73).

dividend yields, because it allows for a smoothing of growth rates reflecting a period when the RHCs were taking large write-offs from plant investment and workforce reductions, causing short-term retained earnings growth rates to be abnormally high in relation to long-run expectations (id. at 76-77). He goes on to state that his method places much greater weight on more recent historical experience (id. at 78 n.49).

The Attorney General argues that an adjustment to the cost of equity to reflect the effects of the RHCs' nonregulated operations is necessary to recognize the upward bias produced by including nonregulated operations in the cost of capital for NYNEX's regulated operations (Attorney General Brief, Part II, at 87-88). He defends his adjustment for nonregulated businesses as conservatively low, given NYNEX's own market security plan analysis (Attorney General Reply Brief at 78). He argues that the Company's own adjustment would reduce the recommended return on equity by an additional 30 basis points (id. at 78-79). Finally, the Attorney General questions the Company's claim that regulated operations are more risky than nonregulated activities, given NYNEX's own analysis supporting a required cost of equity for the RHCs' cellular businesses of 17.76 percent (id. at 79).

(B) NECTA

NECTA supports the Attorney General's recommended return on common equity, based on Mr. Newhard's testimony and other evidence concerning the relative risk of NYNEX (NECTA Brief at 96-97; NECTA Reply Brief at 38). NECTA cites the Company's ability to internally finance construction and that those risk elements it faces are created by its unregulated business activities, including its parent's investment in Viacom and plans to invest in broadband technology (id.). NECTA maintains that the Company's risks are also aggravated by its "chronic" misallocation of costs to intrastate regulated operations, and lack of dividend reinvestment program or employee stock ownership plans (NECTA Brief at 97).

(C) NYNEX

The Company contends that the Attorney General's recommendation, if accepted, would result in a downgrading of its bonds from AA- to A, with severe consequences on its ability to raise capital and invest in new facilities (NYNEX Brief at 166). The Company goes on to challenge Mr. Newhard's qualifications, alleging that by his own admission, Mr. Newhard has never served as a financial advisor to a single investor (id. 145). This relative lack of experience in the financial markets, according to NYNEX, contrasts with the extensive experience and background of its own cost of capital witness (NYNEX Reply Brief at 46-48). The Company argues that the Attorney General has presented the same DCF analysis that the Department rejected in D.P.U. 86-33-G, and thus "low-balled" his estimate of the required cost of capital (NYNEX Brief at 141-142). NYNEX urges the Department to place little weight on the Attorney General's recommendation (id. at 142).

NYNEX characterizes the Attorney General's selection of comparison companies as unrealistically limited (id. at 144). The Company maintains that the Attorney General's reliance on RHCs as the sole components of his comparison group disregards much of the criticism the Department had of a similar analysis by the Attorney General in D.P.U. 86-33-G (id.). According to NYNEX, companies with substantial telecommunications operations, such as the RHCs, have higher current stock prices than supported by the near-term growth estimates, which therefore produce lower dividend yields than consistent with the near-term growth expectations (id. at 145). These higher stock prices, the Company claims, reflect long-term growth potential associated with the foreseen relaxation of the business restrictions placed on the RHCs by the MFJ, which are not reflected in the IBES growth forecasts (id. at 146, citing Exh. NYNEX-10, at 32-34; Tr. 18 at 31-34; Tr. 26 at 65-68). The Company contends that the Attorney General has distorted its testimony on this issue "beyond recognition," and urges the Department to examine the Attorney General's citation of the record with respect to the cost of equity testimony (NYNEX Brief at 146-147).

NYNEX argues that the Attorney General's single-stage DCF analysis is unsupported by the record (id. at 149). Turning to the Attorney General's proposed yield component, NYNEX argues that the use of his comparison group would result in a yield component of 7.50 percent versus 5.72 percent as stated by the Attorney General (id. at 150-151). Furthermore, the Company contends that there is no evidence that the sustainable growth rate is used by investors or analysts, as opposed to other measures of growth such as dividends and earnings (id. at 149-150; NYNEX Reply Brief at 51). The Company claims that the Attorney General's averaging method for historical retained earnings growth with projected Value Line growth rates was not done to account for abnormal highs, but as a means to reduce the forecasted growth rates (NYNEX Reply Brief at 52). NYNEX also faults the Attorney General's failure to consider the impact of historical data on Value Line's projections (NYNEX Brief at 150).

NYNEX also contends that the Attorney General's two-stage DCF analysis is unsupported by the record and is as flawed as the analysis rejected by the Department in D.P.U. 86-33-G (id. at 151-152, citing D.P.U. 86-33-G at 359). The Company argues that the use of combined six- and twelve-month earnings forecasts produces results weakened by the older, more stale data (NYNEX Brief at 152). The Company further criticizes the Attorney General's second-stage growth rate of 5 to 6 percent as devoid of support, and claims that the second-stage growth rate is serving as the driver for the Attorney General's recommendation in disregard of the consensus of professional security analysts (id. at 152-153).

NYNEX points to the two-stage DCF analysis it provided as part of its rebuttal testimony, which relied on IBES data in conjunction with the Attorney General's method of analysis, which the Company contends produced anomalous results that are inconsistent with capital market theory (id. at 154, citing Exh. NYNEX-40, exh. 1). The Company contrasts the Attorney General's results with its own three-stage DCF analysis which establishes a required return of between 13.1 percent and 13.5 percent (NYNEX Brief at 155, citing Exh. NYNEX-40, at 19-20, exh. 2). NYNEX further notes that its "corrected" version of the Attorney General's DCF analysis supports a required return on equity between 13.88 percent and 14.92 percent, in excess of what the Company is proposing in this case (NYNEX Brief at 155-157).

Further understating the Company's risk, according to NYNEX, is the Attorney General's proposed risk adjustment for nonregulated businesses. NYNEX rejects the Attorney General's analysis as unsupported (id. at 160). The Company argues that the Attorney General (1) is attempting to apply his proposed adjustment to a return that NYNEX considers to be too low, (2) has no basis to assume that the cost of equity for the economy as a whole is 12 percent, and (3) improperly assumes that the regulated segment of the Company poses less risk than the unregulated sector (id. at 160-161). According to NYNEX, its recalculation of the Attorney General's results to remove the impact of cellular or other wireless operations on the RHC group produces results that are consistent with the Company's own analyses (id. at 147). The Company urges the Department to reject the Attorney General's nonregulated operations adjustment (id. at 161).

iii. Analysis and Findings

The Attorney General's reliance on RHCs as the basis for his comparison group does not take into account those telecommunications companies that are not covered under the terms of the MFJ, and thus unnecessarily restricts the comparison group. However, as NYNEX is still covered under the terms of the MFJ, the RHC-based comparison group does offer some measure of comparability that the Department will consider in determining the Company's required return on equity.

The market-to-book ratios for the RHCs are considerably greater than one, and exhibit high price-earnings multiples (Exh. AG-792, at schs. 4, 5). The Department has previously noted that in such a situation, a DCF analysis may produce an unreliable result. Cambridge Electric Light Company , D.P.U. 92-250, at 147 n.58 (1993); Commonwealth Gas Company , D.P.U. 87-122, at 109 (1987). Based on the record in this case, we find that the increases experienced in RHC stock prices are at least in part indicative of investors' long-term expectations regarding the MFJ. In any event, the prevailing market conditions do tend to weaken the application of DCF analysis. Accordingly, the Department finds that the Attorney General's dividend yield tends to understate the required cost of equity.

With respect to the Attorney General's dividend growth rate, the sustainable growth rate analysis seeks to address the concerns we have expressed in prior proceedings about the applicability of the retained earnings growth approach. While the Attorney General's method has appropriately attempted to account for the impact of market-to-book ratios on the unadjusted retained earnings growth rate, we find that the sustainable earnings approach still does not capture the full growth potential. Cambridge Electric Light Company, D.P.U. 92-250, at 147 (1992); Berkshire Gas Company, D.P.U. 90-121, at 180 (1990). Based on the foregoing, the Department places little weight on the Attorney General's single-stage DCF analysis.

Regarding the Attorney General's two-stage DCF analysis, we agree with the Company that the use of combined six- and twelve-month earnings forecasts produces results that may understate the required cost of equity. We also find that there is no evidence to support the Attorney General's proposed second-stage growth rate, and concur with the Company that the Attorney General's method appears to produce results that are inconsistent with market theory. Accordingly, the Department shall place no weight on the Attorney General's two-stage DCF analysis.

In regard to the Attorney General's proposed risk adjustment for nonregulated businesses, the Department finds that the limited comparison group used in the analysis, and the lack of support for his proposed 12 percent cost of equity for the economy as a whole, produces unreliable results. Accordingly, the Department places no weight on the Attorney General's proposed risk adjustment.

g. Conclusion

The standard for determining the allowed rate of return on common equity is to preserve the Company's financial integrity, allow it to attract capital on reasonable terms, and be comparable to earnings on investments of comparable risk. Bluefield and Hope, supra.

Based on a review of the evidence presented in this case, the arguments of the parties, and the considerations set forth above, the Department finds that an allowed rate of return on common equity of 11.5 percent is within a reasonable range of rates that satisfies the standards set forth by the United States Supreme Court in Bluefield and Hope, and is appropriate in this case.

D. Rates for the Starting Point for Price Cap Regulation

1. Positions of the Parties

a. Attorney General

The Attorney General argues that in order to determine whether rates for the starting point are just and reasonable under price regulation, the Department must conduct a revenue requirement, cost allocation, and rate design investigation of NYNEX's rates (Attorney General Brief, Part I, at 97-98, citing G.L. c. 159 §§ 14, 17, 19, 20). According to the Attorney General, "only the Company's revenue requirement is being reviewed," and even if the Company's current rates are reduced as a result of this earnings review, as a matter of law, the Department cannot use existing rates as the starting point for price regulation, unless cost allocation and rate design are examined (id. at 97-99; Attorney General Reply Brief at 5). The Attorney General claims that since "the Company's most recent cost allocation and rate design studies are over eight years old," the Department must conduct a review of NYNEX's cost allocation and rate design to determine whether individual rates are just and reasonable before allowing the Company to implement price regulation (Attorney General Brief, Part I, at 97-99). He contends that since the Department's last review of cost allocation and rate design technological changes affecting certain NYNEX services make it imperative that the Department undertake such a review; otherwise, the Department will not be able to ensure that rates will be just and reasonable both at the start and over the term of price regulation (id. at 99-100).

The Attorney General argues that the Company has not shown that its current rates are just and reasonable and an appropriate starting point for alternative regulation (Attorney General Reply Brief at 11). He contends that the Company's current revenues exceed its cost requirements (both expenses and ROR) by $413,513,000, and, unless reduced, current rates will be unjust and unreasonable as rates for the starting point under price regulation (Attorney General Brief, Part II, at 1-2). He also maintains that even if the Department does not approve price regulation for NYNEX, the Company's revenues should be reduced substantially in accordance with his specific recommendations for adjustments to the Company's rate base, expenses, and rate of return (id.).

The Attorney General contends that the Department's finding in D.P.U. 93-125 that rates were "reasonable, in light of the Department's directive in D.P.U. 92-100, to complete the remaining transitional rate changes in no more than three additional filings" was a narrow finding and does not, contrary to NYNEX's assertions, mean that NYNEX's rates can be considered presumptively just and reasonable for an alternative regulation plan (Attorney General Reply Brief at 12-13, citing D.P.U. 93-125, at 10-11). He maintains that the Department specifically excluded parties, including the Attorney General, from litigating cost allocation and rate design in the transitional rate filing proceedings, as well as in the instant proceeding (id. at 13-14).[222] The Attorney General argues that this results in a denial of due process and failure to fulfill the Department's statutory responsibility under G.L. c. 159 (id.).

b. NECTA

In general, NECTA contends that, even if the intervenors' proposed adjustments to NYNEX's revenues, expenses, and investment were made, the Company's current rates cannot be used as rates for the starting point under price regulation because (1) the rates are not cost-based, in the aggregate or on an individual basis, and (2) NYNEX has failed to comply with the Department's revenue requirements precedent and filing requirements (NECTA Brief at 69-74).

NECTA argues that the Department must conduct "a thorough review of cost allocation issues" prior to setting rates for the

[222] According to the Attorney General, "[t]he fact that certain billing determinants have been updated in the Marginal Cost Studies in the Transition cases" does not overcome the deficiencies of stale data, and no review of cost allocation and rate design in this case (Attorney General Reply Brief at 13).

starting point, because the cost allocation method established in D.P.U. 86-33-C is "stale, unrepresentative of the current NYNEX network, fails to take into account changes in technology, fails to take into account new uses of the network for video transport and fails to deal with the parade of nonregulated services which NYNEX has been rolling out" (id. at 70, citing Tr. 4, at 75-81). NECTA cites the Company's Centrex Plus Services as examples of services for which new allocators should be developed (id. at 70-72). NECTA also contends that there is Department precedent for requiring NYNEX to update cost allocators "when revenue requirements are involved" (id. at 71, citing NET, D.P.U. 86-33-C (1989)).

NECTA also claims that the Company has violated the Department's existing cost allocation rules for revenue requirement investigations and has understated the revenues produced under its existing rates (id. at 72-73, citing NECTA Motion for Partial Summary Judgment, and October 17, 1994 NECTA Reply to NYNEX Opposition). According to NECTA, the Company's existing rates are based upon the 12-month period ending November 30, 1992, but the Company used the calendar year 1993 study period for determining the reasonableness of its earnings (id. at 72-73). NECTA maintains that this mismatch would be compounded because "1993 operating results ... are not based upon tariffed services alone," and, on a going-forward basis, revenues would not include earnings from non-tariffed items, such as pole attachment charges and Yellow Pages (id. at 73 n.20). NECTA argues that the Company's study period results do not take into account the growth in demand, as required by Department precedent (id. at 73, citing NET, D.P.U. 86-33-C (1987)). NECTA claims that the Company currently has more access lines and increased usage than it did on November 30, 1992, and that the Company did not quantify such information (id., citing Exh. NECTA-250; NYNEX 1992 and 1993 Annual Returns; NYNEX Corporation quarterly reports through September 30, 1994; NECTA Reply Brief at 25-26). NECTA argues that because NYNEX has not provided an analysis of annual revenues under its existing rates, as requested by NECTA, the current rates are unlawful as rates for the starting point under price regulation (NECTA Reply Brief at 25-26, citing Exh. NECTA-137; Attorney General Motion dated December 28, 1994).

NECTA also asserts that NYNEX's existing rates are not reasonable as rates for the starting point for price regulation because the Department has not completed the transitional rate restructuring process (NECTA Brief at 74, citing D.P.U. 93-125, at 10-11 (1994)). NECTA contends that the current rates were found reasonable as part of one phase of a transitional process that anticipated additional rate changes (id. at 74).

c. FEA

FEA contends that NYNEX's current earnings are not a reasonable starting point for alternative regulation because the Company's revenue requirement has not been examined since D.P.U. 86-33-G (FEA Reply Brief at 7). FEA argues that subsequent changes in technology, investments, expenses, service offerings, tax rates, and affiliate relationships make it necessary for the Department to conduct a revenue requirement examination (id. at 8).[223] FEA maintains that the Company anticipates increased earnings under the plan since NYNEX has not sought a revenue increase prior to implementation of a price cap plan (id.). FEA argues that the Company did not successfully challenge the Attorney General's two allegations that (1) the Company's revenues far exceed the level appropriate for rates for the starting point, and (2) even if price regulation is not adopted, the Department must reduce the Company's revenue requirement (id.).[224] FEA claims that NYNEX's study period expenses are inaccurate because of the temporary effect of PRE (id. at 9). FEA argues that PRE work force reductions substantially will reduce expenses in the next few years (FEA

[223] FEA also claims that a revenue requirement investigation is needed even if the Department adopts earnings sharing as part of the price cap plan (FEA Brief at 19).

[224] The FEA also disputes the Company's assertion that this is not a "revenue requirement" case, arguing that Department "acceptance of the Company's proposals is equivalent to endorsement of its current rate and revenue levels as a starting point for incentive regulation without public hearings" (FEA Reply Brief at 9).

Brief at 23). Moreover, FEA asserts that the Company's earnings filing is suspect because the Company did not include critical data, and that the estimates for 1995 financial results should also be accorded little weight (id. at 20). FEA maintains that the information on 1994 financial results omits such key data as (1) reductions in the costs of facilities and equipment that the Company now purchases, (2) cost savings resulting from improvement in operating procedures, (3) increased revenues because of greater use of existing services by present customers or by new customers, and (4) revenues for new services to be offered by the Company (id. at 21).

FEA also contends that NYNEX's current rates were found just and reasonable in D.P.U. 93-125, with the understanding that they would be in effect until a decision was made on the next annual filing (FEA Reply Brief at 7). According to FEA, since the current rates were only approved on a temporary basis, and are not at the targets set by the Department in the transitional rate restructuring process, they are not the appropriate rates for the starting point for price regulation (id.).

d. NYNEX

NYNEX argues that it has met its burden by making a prima facie showing that its current level of earnings is just and reasonable, and by showing that the Company's existing prices and rate structure are an appropriate starting point for its price cap plan (NYNEX Brief at 18, 116, 123, 126).

The Company claims that its current rates produce a revenue deficiency of $127.1 million or a return on investment of 7.76 percent, "well below the 11.24 percent level approved in D.P.U. 86-33-G" (id. at 123). NYNEX argues that based on the testimony of Mr. Cogswell, the Company's current cost of capital is 11.34 percent, thus confirming the presumption of reasonableness of NYNEX's allowed return of 11.24 percent (id., citing D.P.U. 86-33-G). NYNEX argues that it presented more evidence on its current earnings than it was required to under the Department's July 14, 1994 Interlocutory Order (id. at 126). The Company notes that rather than rely on the presumption that its currently adjudicated and authorized rate of return is prima facie reasonable, it demonstrated in its direct case that its rate of return should be 11.34 percent (id.).

With regard to cost of service issues, the Company asserts that, based on the record evidence, the Department must find, as a matter of law, that the Company's current rates are appropriate for implementing its price cap plan (id. at 128). According to NYNEX, after making certain adjustments during the proceeding and after taking into account five adjustments proposed by intervenors, the Company argues that there is a revenue deficiency of $127.1 million (id. at 124). NYNEX also contends that there is no record evidence to support thirteen of the

Attorney General's proposed adjustments, and that the Attorney General's cross-examination on ten other cost of service issues was inadequate (id. at 128). Finally, the Company argues that the five rate base adjustments suggested by the Attorney General and/or NECTA are not supported by the record (id. at 123).[225] The Company disputes all of NECTA's remaining adjustments.

The Company also contends that its existing prices and rate structure are appropriate for implementation of its price cap (id. at 116). The Company notes that these prices and rate structure were reviewed and approved by the Department in D.P.U. 93-125, as part of the transitional rate restructuring process (id. at 17, citing Exh. NYNEX-8, at 22). NYNEX adds that those rates were found just and reasonable, and that the cost studies supporting such were approved previously by the Department (id. at 17-18). In disputing claims that current rates are based on stale cost data, the Company maintains that in each of the transitional cases, it has filed updated marginal cost studies to confirm the reasonableness of the target rates (id. at 121 & n.42).

2. Analysis and Findings

The earnings review in this proceeding was an unrestricted

[225] NYNEX maintains that the Attorney General and NECTA "have been largely content to make their cost of service cases through their briefs, and have failed to rebut the Company's evidentiary presentation, or show that the current rates are unreasonable" (NYNEX Brief at 124).

examination of the Company's current level of earnings in order specifically to determine whether the Company's current rates are appropriate and reasonable as rates for the starting point in the price cap plan that we adopt for NYNEX. It was not the object of the earnings review itself to set new rates. In order to make this determination of appropriateness and reasonableness, we must decide whether there is substantial evidence that the Company's earnings are reasonable or that the Company is overearning.[226] However, contrary to the Attorney General's suggestion, the Department did not intend, nor was the record sufficient, to determine a specific revenue requirement for the Company as a result of this investigation. The Department noted that if it determined that the Company's current rates were not appropriate as starting rates for a price cap, it might find that an additional investigation was necessary. July 14, 1994 Interlocutory Order at 8.

Consistent with the standard of review for the earnings investigation and based on an examination of the Company's

[226] Arguably, the Department was not compelled by statute to conduct an earnings review, or, for that matter, any investigation on earnings, to determine the reasonableness of NYNEX's current rates as rates for the starting point for price regulation. Again, those rates are deemed lawful until changed. G.L. c. 159, § 17. As noted, supra, the earnings review is important for the Department to have a reasonable degree of confidence that the Company is not receiving monopoly profits, prior to substituting price cap regulation for ROR regulation.

earnings, we must determine whether the Company's current rates are appropriate and reasonable as rates for the starting point in the price cap plan that we adopt for NYNEX. All of the intervenors who addressed this question argue that NYNEX's current rates cannot be used as starting rates under a price cap plan because (1) those rates are yielding more than a reasonable return; and (2) the Department did not examine cost allocation and rate structure in this proceeding. Both of these arguments are addressed below.

a. Reasonableness of Earnings

The Company's current rates, which went into effect on April 14, 1994, were found just and reasonable pursuant to our Order of January 13, 1994 in D.P.U. 93-125, and are "deemed *prima facie* lawful" and presumptively reasonable "until changed or modified by the [D]epartment." G.L. c. 159, § 17;[227] *see* D.P.U. 93-125. Despite the presumptive reasonableness of existing rates, and consistent with the purpose of the earnings review and NYNEX's filing, the Company has the burden of affirmatively demonstrating that its rates are reasonable and appropriate as initial rates in a price cap plan. The propriety of continuing to charge lawfully established rates is a distinct

[227] Nevertheless, Section 17 makes clear that the Department should not give "any greater weight [to existing rates] as evidence of the reasonableness of other rates than they would otherwise have." G.L. c. 159, § 17.

question from whether the earnings level implicit in those rates is a suitable starting point for price cap regulation. For this reason, the Department ensured that NYNEX had to present evidence of such suitability and permitted the intervenors unfettered inquiry into the latter question. Only if the Department could fairly conclude that the earnings level under established rates was suitable would it permit the price cap plan to proceed based on those earnings. Even though there is no statutory requirement to conduct an earnings review prior to implementing a price cap, the Department determined that it would be appropriate to do so. Based on the results of the earnings review and for the reasons stated below, we find that the Company has met its burden and has thereby established the reasonableness of its current rates as the basis for the price cap plan.

As noted earlier, in conducting its earnings review, the Department allowed parties, if they so chose, to examine fully two broad issues: (1) whether the Company's currently authorized rate of return is reasonable, and if not, what is a reasonable return for NYNEX; and (2) whether the Company is currently earning more than a reasonable return as shown by an examination of its revenues, expenses, and rate base.

With respect to the first issue, the Department stated in its July 14, 1994 Order that there is a presumption that the Company's adjudicated and authorized rate of return is *prima* facie reasonable. July 14, 1994 Interlocutory Order at 7. NYNEX presented evidence to demonstrate that its allowed return remains reasonable by today's standards. However, based on the evidence presented by the Company and the Attorney General, the Department found in Section VII.C, supra, that NYNEX's currently authorized ROI of 11.24 percent is not reasonable by today's standards and found that a reasonable return for the Company is 9.63 percent.

With regard to the second issue, i.e., whether the Company is currently earning more that a reasonable return given the evidence presented in this case on NYNEX's revenues, expenses (including a 9.63 ROI), and rate base, as an initial matter, we find that the Company has properly reflected in its initial filing the cost of service adjustments required by the Department's findings in D.P.U. 86-33-G. See D.P.U. 86-33-G. The Company has also made adjustments to reflect what it considered to be appropriate annualizations for certain cost items, thereby increasing its overall cost of service above what it reported in its initial filing. In Section VII.C, supra, the Department made findings on 22 adjustments proposed by intervenors. Consistent with our findings on those proposed adjustments (including those adjustments to which NYNEX agreed), we further find that there is not substantial evidence to conclude that the Company's current rates produce overearnings. In fact, after accounting for all of the Department-approved adjustments, our earnings review demonstrates that substantial record evidence supports the conclusion that the Company's current ROI is almost identical to the ROI approved by the Department, supra.[228] (A breakdown of our specific findings on NYNEX's 1993 study period cost of service is set forth in the schedules attached to this Order.) Accordingly, we find that NYNEX's current rates are reasonable as rates for the starting point under the price cap plan we approve for NYNEX in this Order, and we find that further proceedings on the Company's rates are not warranted.

Our determination that it is not necessary or appropriate to conduct further proceedings on the Company's rates is based on several factors: (1) the breadth of the earnings review, which indicated that the Company's current earnings are reasonable;[229] (2) the application of the price cap index, which provides benefits to ratepayers and allows the Company to increase its earnings only through above-average productivity gains (see Section V.A.2.b.i); (3) the freeze in basic residence service

[228] As noted on Schedule 1, infra, the earnings review indicates that the Company's revenues exceed its cost of service by $216,000 (or .0001 percent of its current revenues).

[229] In fact, the Attorney General argued that the earnings review was comprehensive enough actually to constitute a revenue requirement investigation (see Attorney General Brief, Part I, at 18). However, regardless of the breadth of the investigation, as noted earlier, it cannot be considered a formal revenue requirement investigation.

rates, which account for roughly 30 percent of the Company's revenues (see Exh. NYNEX-39, at 1-2); (4) the Company's incentive and ability to achieve a more economically efficient pricing structure under the price cap plan (see Section VI.C.2.b); and (5) the shift of investment risk under price cap regulation from regulated ratepayers to the Company's shareholders (see Section V.C.2).

b. Cost Allocation and Rate Design

The intervenors also claim that the Company's current rates cannot be found reasonable as initial rates for a price cap plan because the Department did not examine cost allocation and rate design in this case. The Department found at the start of this proceeding that it was not necessary to review cost allocation and rate structure in order to determine whether the Company's current rates are appropriate as starting rates for price cap regulation. See June 14, 1994 Interlocutory Order at 22; July 14, 1994 Interlocutory Order at 7. It was implicit in that finding, notwithstanding the claims of intervenors, that there is no legal requirement to conduct such a review. Prior and subsequent to that decision the intervenors failed to cite any specific legal requirement, apart from their general reference to the rates and tariff provisions of G.L. c. 159, to support their contention. The Department undertook the earnings review in this case principally to ensure that the regulatory initiative represented by the Plan would not work to the disadvantage of the Company's customers.

Again, NYNEX's current rates are "deemed prima facie lawful until changed or modified by the [Department]". D.P.U. 93-125; G.L. c. 159, § 17. [230] The cost allocation and rate structure on which those rates are based are also deemed reasonable until changed by the Department. Absent a specific legal requirement compelling the Department to conduct an investigation of cost allocation and rate design, we have the discretion to structure our proceeding in a manner appropriate to our regulatory purpose and to the demands of due process. Thus, while we considered it useful and necessary to conduct an earnings review to judge whether the Company's current rates were appropriate and reasonable for use as the initial rates under price cap regulation, we did not -- and still do not -- consider it necessary to re-examine cost allocation or rate design. [231] An

[230] Even though the Department in this Order has discontinued the transitional rate restructuring process (see Section V.B.2, supra), the Company's current rates remain just and reasonable, without condition, until changed or modified. G.L. c. 159, § 17 ("[Rates] heretofore established and set out in any schedule filed [with the Department] shall be deemed prima facie lawful until changed or modified by the department...").

[231] NECTA's arguments regarding NYNEX's failure to comport with cost allocation and filing requirements have been addressed in Section II.B.1, supra. In addition, the Department did not require NYNEX to provide as part of its earnings review filing data on demand growth under existing rates. Under a traditional revenue requirement investigation or full rate

examination of cost allocation or rate design is not necessary to achieve our goal of an economically efficient rate structure. As noted earlier, the pricing rules of the price cap plan will allow and should encourage increased economic efficiency in NYNEX's rates.

The Company's COSS and MCS, which are the basis of its current cost allocation and rate design, were examined in detail and approved by the Department in D.P.U. 86-33-C, D.P.U. 86-33-G and D.P.U. 89-300. As noted earlier, in D.P.U. 89-300 the Department examined NYNEX's rate structure, based on the approved COSS and MCS. D.P.U. 89-300. The Department's decision in D.P.U. 89-300, issued in 1989, marked the beginning of the multi-year transitional rate restructuring process (discussed extensively, supra). Id.; see 91-30; D.P.U. 92-100; and D.P.U. 93-125. For each transitional filing, NYNEX was required to file updates to its COSS and MCS as part of its supporting documentation, which, though not approved by the Department in those proceedings, were utilized by the Department in making its decisions in the transitional rate filing cases. D.P.U. 93-125, at 14.

case, the Company would be required to provide this information. However, as we noted earlier, given the unique nature of this proceeding, the Department has not applied rate case precedent rigidly, and lack of such information did not hinder the Department's ability to assess the reasonableness of current rates. See Section II.B.1, supra.

Moreover, while the Attorney General does not agree with the Company's current cost allocation and/or rate structure, the fact remains that the issues were extensively litigated in prior proceedings, in which he and many of the other intervenors in this proceeding participated. For this reason, we fail to see how the Attorney General or any other party was prejudiced by exclusion of these issues in the instant proceeding.

For all of the above reasons, we find that NYNEX's current rates are appropriate and reasonable rates with which to begin price cap regulation, and, accordingly, we find that an additional investigation is not needed.

VIII. ORDER

Accordingly, after notice, hearing, and due consideration, it is

ORDERED: That the petition of New England Telephone and Telegraph Company d/b/a NYNEX for an Alternative Regulatory Plan for the Company's Massachusetts intrastate telecommunications services is hereby DENIED in part, and APPROVED in part as described herein, and it is

FURTHER ORDERED: That New England Telephone and Telegraph Company d/b/a NYNEX shall comply with all directives contained herein.

By Order of the Department,

Kenneth Gordon, Chairman

Mary Clark Webster, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).