STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 6914

Investigation into the Existing Rates of Shoreham Telephone Company, Inc.	))	Technical Hearings at Montpelier, Vermont May 25, 26, and 27, 2004

Order entered: November 4, 2004

PRESENT: Peter B. Meyer, Hearing Officer

APPEARANCES: Paul J. Phillips, Esq.
Cassandra C. Larae-Perez, Esq.
Primmer & Piper, P.C.
for Shoreham Telephone Company, Inc.

June E. Tierney, Esq.
for Vermont Department of Public Service

I. Introduction

Shoreham Telephone Company, Inc. ("Shoreham" or the "Company") is a very well run, locally owned, small telecommunications company that has been providing high quality services to its customers for many decades. However, for the past few years, disparities in federal and state cost allocation and recovery methodologies have allowed Shoreham to have very large net profits that have allowed it to realize an overall rate of return on its investment that substantially exceeds industry norms and is of a magnitude that is unjust and unreasonable.

In 2002, the Company collected $3.56 million from Vermont customers and other sources. Of that amount, $2.35 million was used to cover expenses, and the remaining $1.21 million of net operating income ("profit") was distributed to Shoreham's owners.[1] The $1.21 million in profit amounted to a return of 38.8 percent on their remaining investment (the owners had already been paid back all but $3.12 million of their past investments). That rate of return greatly exceeds the usual rate of profit for telephone companies of comparable risk and was the Public Service Board's ("Board") basis for opening this investigation.

The Company suggests it should be allowed to collect total revenues of $3.509 million, while the Department of Public Service ("DPS" or "Department") now recommends setting Shoreham's rates at a level expected to collect $2.39 million in revenues. For all of the reasons set out below, I conclude and recommend that an annual revenue level of $2.68 million ($290,000 higher than that recommended by the Department) would be just and reasonable for this company.

My decision is based on several findings relative to adjustments to Shoreham's cost of service and cost of capital, as well as my recommendation that the Board adopt the "total company" ratemaking methodology as the most appropriate mechanism for determining just and reasonable rates. Use of this ratemaking methodology will ensure that Shoreham, unlike the present situation, will recover no more than 100% of its cost of providing services to its customers, plus a reasonable rate of return on its investment.

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1. The Company pays no corporate income taxes because it is structured as a Subchapter S corporation. Thus, all net income is passed directly to Shoreham's owners.

II. Procedural History

On September 2, 2003, Shoreham, along with other Independent Telephone Companies of Vermont[2], filed with the Board and the DPS supplemental financial reports to their 2002 Annual Reports. These supplemental reports provided information about the financial operations of Shoreham and other Independent Telephone Companies in a different format than had previously been used.[3] On November 20, 2003, Board staff met with Shoreham, Shoreham's accountants and the DPS to discuss Shoreham's financial results and supplemental reports. Following this meeting, and as requested, Shoreham's accountants filed two revised supplemental reports. Based on these reports, including the revised supplemental reports filed by Shoreham's accountants, the Board concluded that there is a significant possibility that Shoreham's rates are higher than a just and reasonable level. Consequently, the Board opened this investigation pursuant to 30 V.S.A. § 227(b) into the justness and reasonableness of Shoreham's existing rates, as well as an examination of:

(1) known and measurable changes in operations;
(2) appropriate capital structure;
(3) appropriate cost of equity; and
(4) benefits (and costs) of establishing Shoreham's rates using a total company (or residual) methodology.

A prehearing conference was convened on January 16, 2004. Shoreham and the DPS were the only parties that participated in the prehearing conference.

A scheduling order was issued on February 13, 2004.

On February 17, 2004, Shoreham filed the direct testimony of witness Clifford A. Abbott.

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2. The nine independent telephone companies are: Franklin Telephone Company; Ludlow Telephone Company; Northfield Telephone Company, Perkinsville Telephone Company; Shoreham Telephone Company, Inc.; STE/NE Acquisition Corp., d/b/a Northland Telephone Company of Vermont, d/b/a FairPoint New England; Topsham Telephone Company, Inc., Vermont Telephone Company, Inc., d/b/a Vtel; and Waitsfield-Fayston Telephone Company, Inc., d/b/a Waitsfield Telecom, d/b/a Champlain Valley Telecom.

3. Although the format of the financial reports provided by the Independent Telephone Companies was different from the format of the financial reports previously filed with the DPS and the Board, the method for analyzing the companies' 2002 earnings was identical to the method used in prior years.

On April 5, 2004, the Department filed the direct testimony of witnesses Ronald Behrns, Ralph Smith, and Dr. Jonathan Lesser.

A notice of a technical hearing was sent on May 13, 2004, to all parties and interested persons. The notice announced a schedule for technical hearings on May 25-27, 2004.

On May 17, 2004, Shoreham filed the rebuttal testimony of witnesses Clifford A. Abbott and John T. Gurley.

On May 21, 2004, the Department filed the rebuttal testimony of witnesses Ronald Behrns, Ralph Smith, Dr. Jonathan Lesser and Lawrence Lackey.

Technical hearings were held as scheduled on May 25-27 in the Public Service Board's hearing room on the 3rd floor of the Chittenden Bank Building at 112 State Street, Montpelier, Vermont.

Shoreham and the Department were the only parties that participated in the technical hearings.

III. Legal Standard of Proof

A. Issue and Positions of the Parties

Shoreham argues that the Department bears the burden of proof as the proponent of a change in existing rates, and bears a substantial burden of proof as the proponent of radical, immediate and profound changes in established regulatory policy. It suggests that the Company has neither petitioned for, nor proposed, any change, either in its existing rates or in the underlying policies that produced those rates. Instead, Shoreham maintains, the Board opened this investigation on its motion, and the DPS, in filings in this docket, has recommended significant reductions in Shoreham's existing rates that will only be achieved if the Board also adopts a number of the significant changes in ratemaking policy advocated by the DPS, including the use of "total company" ratemaking, a revised method of imputing income-tax expense for public service companies that elect tax treatment under Subchapter S of the Internal Revenue Code or other types of pass-through entities for income-tax purposes, and a new requirement that would obligate public service companies to justify their cash working capital allowances.

Shoreham argues that it is established administrative law that where there is no petitioner or movant in a case such as this, the burden of proof is assigned to the party that is the proponent of a change in rates.[4] This general doctrine is further underscored when the DPS, in cases such as this, propose significant changes in established Board policy as justification for significant rate reductions. Consequently, the DPS must bear the substantial burden of proof to justify its recommendations. Given the record in this case, Shoreham argues that the DPS has fallen short of meeting its burden in ths docket.

The DPS counters Shoreham's arguments by citing Board Rule 2.402(B) which states:

> Changes from previous order. When a request for a change in rates proposes or utilizes any change in the ratemaking methodology or principles approved or utilized by the Board in the most recent rate order affecting the same utility, such change shall be clearly identified, and a statement of the reasons for such change shall be given.

The Department maintains that it has met all of the elements of this rule because its witnesses in their testimony clearly identify the proposed changes that it advocates, and they outline in detail the reasons for the recommended changes. Therefore, Shoreham's contentions must fail.

The Department further argues that based on Board Rule 2.402(A), Shoreham bears the burden of proof in establishing the justness and reasonableness of the rates that it seeks to charge ratepayers. In seeking approval of its rates, the burden of production may shift, but the burden of persuasion as to the justness and reasonableness of its rates always lies with Shoreham. It is appropriate for the burden to be on the utility because the utility has the best access to the information relative to the rates proposed. While a utility's expenditures that purport to justify a company's rates are entitled to a presumption of reasonableness initially to meet their burden, this presumption disappears, the DPS argues, upon a mere showing by an adverse party sufficient to allow a finding to the contrary. Even if the above arguments only apply to utilities that have sought rate increases as the rule and supporting case cited by the DPS[5] imply, there is no binding authority or reason why the burden of proof should migrate depending on who initiated the case

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4. *Algonquin Gas Transmission Co. v. F.E.R.C.*, 948 F.2d 1305, 1312 fn. 11 (D.C. Cir. 1991).

5. Docket 5132, *Tariff Filing of Central Vermont Public Service Corporation Requesting a 12% Increase in Rates to Become Effective June 2, 1986,* Order of 6/20/86 at 3–4; Order of 5/15/87 at 87–89.

or whether the proceeding seeks a reduction or the *status quo*. Notwithstanding these arguments, and assuming *arguendo* that the burdens of proof and persuasion belong to the Department, the DPS maintains that it has more than carried its burden in this proceeding.

Discussion

I do not find persuasive Shoreham's arguments that the burden of proof should be on the DPS. This investigation was initiated by the Board because financial reports filed by the Company provided sufficient reason to examine whether Shoreham's rates are just and reasonable. Because the Board is requiring the Company to justify its current rates, Shoreham has the burden of proof.[6] The DPS, as a party to the case and not the initiator of the case, can not, and does not, have this burden of proof. Moreover, the Board has consistently assigned the burden of proof to the utility because it has the best access to the data necessary to the rate levels that the company maintains are reasonable.

Regarding the burden of persuasion for what Shoreham acknowledges are policy changes advocated by the DPS, I see no basis to change the burden of proof. The Department's obligation is to put forth sufficient basis to show that its recommendations are reasonable. Based on its testimony and filings which clearly identified proposed changes and provided supporting rationale, the DPS has fully complied with this requirement.

Finally, even if the Board were to find that the burdens of proof and persuasion were on the DPS, I recommend that the Board find below that the Department has met its burden for those issues on which this Proposal for Decision adopts the Department's proposals, for the reasons set forth below in the discussions of those issues. I thus conclude that, even if the Department bears the burdens of production and persuasion, it has carried those burdens such that a significant rate reduction is in order for Shoreham's customers.

IV. FINDINGS OF FACT

Based on the substantial record evidence and the testimony presented at the technical hearings, I hereby make the following findings to the Board pursuant to 30 V.S.A.§ 8.

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6. *See* e.g., *Citizens Utilities Company*, Dockets 5841/5859, Order of 6/16/97 at 89 (where the Board assigned the burden of proof to Citizens to show its demand-side management accounts were reasonable).

A. General Findings

1. Shoreham Telephone Company, Inc., was incorporated in 1894. Tr. 5/27/04 at 112 (Arnold).

2. The Company is a family-owned business that has been continuously owned by members of the Arnold family since 1949. Tr. 5/27/04 at 110 (Arnold).

3. Shoreham is a Vermont Incumbent Local Exchange Carrier (ILEC) that serves approximately 3,700 access lines in its service territory. Exh. Board 1 at 33.

4. Shoreham operates in interstate and intrastate jurisdictions, and provides non-regulated services such as internet connectivity, customer premise equipment and long distance toll resale. Shoreham provides its internet access services through a division known as Shoreham.net. Abbott pf. at 3; Smith pf. at 26-27.

5. Shoreham serves the exchanges in the towns of Benson, Hubbardton, Orwell, Whiting, Shoreham, Cornwall, Bridport, Weybridge, Addison, Panton, Sudbury and a portion of Castleton. Tr. 5/27/04 at 86 (Lesser).

6. Shoreham is a Vermont Subchapter S corporation for income tax purposes. Behrns pf. at 6.

B. Ratemaking Methodology

7. For purposes of recovering their federal jurisdictional costs from the interstate settlement pool, the Federal Communications Commission ("FCC") categorizes telephone companies as either "cost companies" or "average schedule" companies. Abbott pf. at 7.

8. A "cost company" is required to prepare an annual jurisdictional separations study and to report its actual interstate costs to the National Exchange Carrier Association ("NECA"); its cost recoveries are tied exactly to the actual interstate costs it reports. Abbott pf. at 7.

9. The FCC allows some companies to base their interstate rates upon an "average schedule" that is compiled by NECA. This average schedule adopts generalized industry data to reflect the cost of a hypothetical exchange. Smith pf. at 11; Abbott pf. at 7.

10. An average schedule company is not required to prepare an annual separations study (i.e., cost study) or report its actual cost to NECA. Abbott pf. at 7.

11. The average schedule method can be considered to be a form of incentive regulation, in that companies using this method have an incentive to keep their actual cost below the national average cost. As long as an average schedule company's actual interstate costs are lower than the national average, it is in the company's financial interest to remain an average schedule company. If an average schedule company's actual costs exceed the national average, then it is economically advantageous to elect to become a cost company. Abbott pf. at 9.

12. An average schedule company that files a cost study for use in the intrastate jurisdiction only and remains on the FCC's average schedule in the interstate jurisdiction can have revenues that produce an over-recovery of costs (i.e., more than 100% of total costs) because of the company's reliance on different cost recovery methods in the different jurisdictions. Smith pf. at 12; Behrns pf. at 15.

13. Under the "total company" (or "residual") ratemaking methodology, as applied to an average schedule company, the intrastate revenue requirement is equal to the company's total revenue requirement less interstate cost recovery, as determined by NECA's average schedules. Smith pf. at 11; exh. DPS 7.[7]

14. Several states rely on the total company methodology for their own intrastate ratemaking purposes. Smith pf. at 11.

15. Shoreham has been classified as an average schedule company since 1982. Tr. 5/25/04 at 118 (Behrns).

16. The average schedule methodology allows Shoreham to use national average costs in determining its interstate jurisdictional revenue requirement, regardless of its actual costs. Behrns pf. at 15. The average schedule methodology also relieves Shoreham of the expense of having to prepare and file cost studies. Smith pf. at 11.

17. Shoreham's actual interstate costs are less than the national average interstate costs. Behrns pf. at 15.

18. Shoreham has, in the past, considered converting from an average schedule company to a cost company. Each time, it has concluded that converting to a cost company would not likely result in ratepayer benefits. Abbott pf. at 9; tr. 5/25/04 at 59 (Abbott).

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7. *See* also *Pine Tree Tel. v. Public Utilities Commission*, 631 A2d 57 (Me. 1993);

19. If Shoreham elects to abandon average schedule treatment and become a cost-based company, there would be no immediate change in intrastate rates, but the Company would incur additional costs of approximately $100,000 for cost of service studies and additional personnel. These additional costs would eventually lead to higher rates for Shoreham customers. Abbott pf. rebut. at 15–16.

20. Shoreham has filed a "proxy" cost study in this proceeding (hereinafter referred to as a Proxy cost study). The Proxy cost study uses some Company-specific data and certain FCC factors to determine Shoreham's intrastate costs. Abbott pf. at 8.

21. Shoreham's Proxy cost study relies upon calculations that appear to be inconsistent with the FCC's Part 36 regulations and NECA's guidelines. Smith pf. at 8.

22. The accuracy and appropriateness of Shoreham's Proxy cost study are questionable. Smith pf. at 9.

23. Based on its Proxy ratemaking methodology, Shoreham calculated a revenue deficiency of $168,028. Abbott pf. at 6; exh. STC-1, Schedule 4.

24. After making several adjustments, the Department concluded that Shoreham is over earning in the amount of $371,000 using Shoreham's Proxy model which included unconfirmed jurisdictional separation factors. Smith pf. at 9; exh. DPS-5, Schedule A.

25. Establishing Shoreham's intrastate revenue requirement according to the "total company" methodology would limit cost recovery to 100% of cost of providing telephone service. Behrns pf. at 16; Smith pf. at 15-16.

Discussion

(1) Background

The Board routinely sets rates based upon a company's costs, using a test year which is then adjusted for known and measurable changes. For telephone companies, the Board also must consider what are the appropriate jurisdictional (i.e., intrastate) costs. One of the most significant issues in this proceeding is the determination of an appropriate ratemaking methodology for making these jurisdictional cost allocations and calculating Shoreham's intrastate revenue requirement. In order to make this determination, it is first necessary to understand the difference between a "cost company" and an "average schedule" company.[8]

A cost company is an ILEC that annually files with the FCC company-specific cost studies in compliance with 47 C.F.R. § 36. These cost studies are costly to complete.[9] 47 C.F.R. § 36 requires an ILEC to specifically label a portion of its total costs as interstate costs depending on specific traffic studies as well as direct and indirect cost assignments. The remainder of an ILEC's costs are designated intrastate and are to be recovered from intrastate services.[10]

In contrast, average schedule companies are not required to file annual cost studies with the FCC. Instead, these companies estimate their interstate costs using "average schedules" which are generalized industry data intended to reflect the average interstate costs of a hypothetical local exchange company.[11] Based on this generalized industry data, an average schedule company receives compensation from the interstate settlement pool for the use of its facilities that originate or terminate interstate telephone calls.

In theory, the average schedule method acts as a form of incentive regulation.[12] To the extent that an average schedule company is more efficient than the hypothetical local exchange company reflected in the average schedule, then the benefits of such interstate efficiencies could

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8. Under the FCC's rules, ILECs are allowed to choose whether to be cost companies or average schedule companies. However, the FCC's rules preclude an ILEC that has chosen to become a cost company from converting back to an average schedule company at a later time. Waivers of the FCC's rules are possible, although highly unlikely. Abbot pf. at 8.

9. Abbott pf. at 8.

10. For example, if interstate costs equal 25 percent of total company costs, then the remaining 75 percent of the ILEC's costs are to be recovered from intrastate services.

11. *See* Shoreham Initial Brief at 6. The precursor to the "average schedule" plan of compensation was a process known as "settlements." The settlement process, which was allowed by the FCC, enabled AT&T, prior to the 1982 divestiture, to redistribute its revenues to small ILECs, such as Shoreham, based on a set of negotiated formulas. Payments frm AT&T were intended to pay small ILECS for the cost of originating or terminating interstate calls made by AT&T's customers on the ILECs' networks. The settlement process eventually became the average schedule system. *See, Pine Tree Telephone and Telegraph Company, et al. v. Public Utilities Commission,* Supreme Judicial Court of Maine, August 23, 1993, at 63 (hereinafter referred to as *Pine Tree v. PUC*).

12. Abbott pf. at 9.

accrue to the shareholders of the average schedule company.[13] However, depending on the methodology used to set a company's intrastate rates, this also means that an average schedule company has the opportunity to recover more than 100 percent of its revenue requirement.[14]

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13. *Policy and Rules Concerning Rate for Dominant Carriers,* 5 F.C.C.R. 6786, 6820 (1990), as restated in *Pine Tree v. PUC.*

14. In *Crockett Telephone Company,et al v. FCC* 963 F. 2d 1564 U.S. App. D.C. 397 (1992), (hereinafter referred to as *Crockett),* the DC Circuit Court of Appeals, in an admittedly oversimplified, hypothetical example described how an average schedule company could recover more than 100% of its costs:

> *Situation 1: Pure Cost Method*
> Suppose Carrier has total costs of $100; it has a right to recover these costs in rates set by appropriate authorities. It conducts a Part 36 cost study annually and ascertains that $25 of the $100 is due to interstate service, and, consequently, $75 to intrastate service. It is entitled to receive those sums from the appropriate customers under rates set by governmental authorities. There is no dispute. In sum:
>
> | | |
> |---|---|
> | Total Costs | $100 |
> | Interstate Costs | $25 |
> | Intrastate Costs | $75 |
> | Allowed Costs | $100 |
>
> *Situation 2: Pure Averaging*
> Now suppose that Carrier chooses to go on the average schedule system for obtaining its interstate payments. Its true costs are still the same as above. Yet, suppose the average schedule allows $35 for interstate service. Residual ratemaking by the states would simply take Carrier's total costs ($100) and subtract the amount recovered from the average schedule ($35) and, thus, allow Carrier to recover $65 in intrastate charges.
>
> | | |
> |---|---|
> | Total Costs | $100 |
> | Interstate Average | $35 |
> | Residual Costs | $65 |
> | Total Allowed | $100 |
>
> *Situation 3: Mixing Average Schedules and Cost Methods*
> Petitioners seek to use the average schedule on the federal level while employing the cost method on the state level allowing Carrier more cost basis in total ratemaking than its actual costs:
>
> | | |
> |---|---|
> | Total Costs | $100 |
> | Interstate Average | $35 |
> | Intrastate Costs | $75 |
> | Total Allowed | $110 |
>
> Thus, if we allow the present situation, a carrier using an average schedule to calculate costs of interstate service but determining actual costs for intrastate ratemaking could be provided with a total base for rate calculation exceeding 100% of its costs. *Crockett* at 401, 402.

In Vermont, the Board has historically used the cost method to set ILECs' intrastate rates. That is, an ILEC's intrastate rates have been based on the company's actual costs to provide intrastate service in an historic test year, adjusted for known and measurable changes. As illustrated in the D.C. Circuit Court of Appeals example cited in footnote 13, when a company's intrastate rates are determined using the cost methodology and its interstate rates are determined using the average schedule methodology, there is the potential for a company to collect more than its total costs.

To address the potential that mixing of interstate and intrastate ratemaking methodologies will lead to ratepayers paying rates that will produce revenues that will exceed the total costs of the company, some states have set intrastate rates for average schedule companies using a "total company" ratemaking methodology. Under the total company methodology, a company is initially considered to be a single entity with a single unseparated revenue requirement. Then, an ILEC's interstate revenue requirement is determined using the FCC's average schedules. Next, the interstate revenue requirement is subtracted from the ILEC's total costs, and the remainder is the ILEC's intrastate revenue requirement. The D.C. Circuit Court described the total company methodology as follows:

> Just as the states subtract from the total cost base of a Part 36 carrier that part determined by FCC regulation to be interstate, many states deduct from the total cost of an "average schedule" company that part attributed by the average schedule to interstate usage and treat the residuum as intrastate. This intrastate method in known as "total company" or "residual" rate-making. Put simply, the residual rate-making state assumes that the intrastate revenue requirement is equal to the company's total revenue requirement less revenues deemed by the average schedule to be interstate.[15]

Shoreham is currently an average schedule company.[16] As such, it is not required to file annual cost studies with the FCC, and instead uses average schedules to estimate its interstate revenue requirement. In Shoreham's most recent prior intrastate ratemaking proceeding, the Company used a Proxy cost study to calculate its intrastate revenue requirement, but the Board

15. *See Crockett*.

16. Abbott pf. at 7.

did not rule on the appropriateness of this methodology.[17] The issue before me in this proceeding is whether to use Shoreham's Proxy cost study or the total company methodology to determine Shoreham's intrastate revenue requirement.

(2) Positions of the Parties

(a) Legal Issue

The DPS urges the Board to adopt the total company ratemaking methodology, while Shoreham argues that the Board should reject the use of this methodology. Shoreham's primary argument is that the Board is without jurisdiction to make this policy change as recommended by the DPS. Shoreham contends that interstate revenues would be used to reduce intrastate rates as a result of the adoption of the total company methodology. In this case, Shoreham's intrastate revenue requirement would, for the first time, be calculated as the residuum of its total company costs minus its interstate revenues as determined by its average schedule costs. The Company maintains that the Board lacks jurisdiction under Vermont law to use revenues from interstate operations to establish just and reasonable rates, and, therefore, must reject the DPS' recommendation as contrary to long-settled Vermont law.

Shoreham bases this argument on a 1949 Vermont Supreme Court case which reversed a rate order issued by the then-Public Service Commission that, according to Shoreham, plainly prescribed the extent of the Commission's jurisdiction in determining telephone company rates:

> [I]t needs no citation of authorities to show that the jurisdiction of the commission extends only to intrastate operations and matters pertaining thereto. It is so limited by statute. V.S.A. § 9360. The amount of property in this state devoted to interstate operations cannot properly be included in a rate base used to determine just and reasonable rates to be charged for intrastate service. No "end result" could be said to be just and reasonable when reached by such a method.[18]

The statute cited in that case, § 9360, was subsequently amended by the Legislature and renumbered as 30 V.S.A. § 203, but not changed in relevant part. The Supreme Court, Shoreham

17. Docket No. 6401, *Investigation into the Existing Rates of Shoreham Telephone Company, Inc.,* Final Order of 2/21/2001. In this case, the Board approved a "bottom line" settlement between Shoreham and the DPS.

18. *Petition of New England Telephone & Telegraph Co.*, 115 Vt. 494, 503 (1949) (hereinafter referred to as "*New England Telephone*").

argues, has made it unmistakably clear that the Board is prohibited from including interstate operations in the rate base used to determine intrastate rates.

Shoreham suggests that the DPS relied only on non-Vermont decisional law to advance its recommendation to use the total company methodology. First, the Company cites the DPS' reliance on the Court of Appeals for the District of Columbia, case *Crockett Telephone Co. et al. v. F.C.C.*, 963 F.2d 1564 (D.C. Cir. 1992). This case held that the power of a state to employ the residual ratemaking methodology for average schedule companies is not preempted by federal law, but it did not address any prohibitions regarding the use of this methodology in state law. Next, Shoreham suggests that the use of two state cases regarding total company ratemaking – *Petition of Mid-Plains Telephone, Inc.,* Docket No. 3650-DR-100, Final Order (Wisconsin Public Serv. Comm'n, Mar. 14, 1989) and *Pine Tree Telephone & Telegraph Co.* v. Public Utilities Commission, 631 A.2d 57, 65-66 (1993) – are not appropriate precedent and should be disregarded because in these decisions the state commissions relied either on an historic use of "residual ratemaking" in the state, or on a recent state legislative enactment that authorized this ratemaking methodology in the state.

The DPS rejects Shoreham's analysis and argues that a careful reading of the *New England Telephone* opinion clearly shows that Shoreham has misconstrued the Vermont Supreme Court holding in that case and is, therefore, without merit. Consequently, the Board is free, if it so chooses, to use the total company methodology to establish just and reasonable rates for Shoreham's ratepayers.

Specifically, the DPS suggests that Shoreham's arguments are based only on a lone passage of the *New England Telephone* case where the Vermont Supreme Court simply reiterates the point (which the DPS does not dispute) that interstate *property* cannot properly be included in a rate base used to determine just and reasonable intrastate rates. At issue in the case was whether just and reasonable intrastate rates could be determined based on an incomplete evidentiary record of a proceeding in which the Commission declined to make certain findings regarding, *inter alia*, rate base and expenses. The Court remanded the case for further fact finding, having found that such fact finding was a prerequisite for appellate review.

The DPS argues that the telling sentence in the *New England Telephone* decision makes no mention of interstate revenues in the context of determining what to include and exclude from a rate base for ratemaking purposes, and the terms property and revenues are neither identical nor interchangeable. The Court did not rule on the reasonableness or legality of aggregating interstate and intrastate revenues for purposes of deducing the intrastate costs underlying intrastate rates. Consequently, the DPS suggests that the *New England Telephone* case does not state either a controlling or a permissive rule that supports Shoreham's jurisdictional claims.

Based on my review of the *New England Telephone* case, as well as the *Crockett* and relevant state cases, I recommend that the Board find that it has the authority to adopt the total company ratemaking methodology for determination of just and reasonable rates for the Company.[17] Essentially, I agree with the DPS that the Company has misconstrued the meaning of the *New England Telephone* decision and there is nothing in the decision that would prevent the Board from adopting total company ratemaking. Specifically, the *New England Telephone* decision should only be applied to the narrow issue that was before the court – whether interstate *property* can be included in the rate base used to determine intrastate rates. In that case, the Supreme Court found fault with the use of total company *rate base* to set intrastate rates, as such a methodology would cause customers to overpay intrastate rates.

Total company ratemaking does not use the company's total rate base to set intrastate rates, nor does it include interstate property in the rate base used to determine intrastate rates. On the contrary, total company ratemaking is premised on the fact that a company's costs must be allocated between interstate and intrastate jurisdictions. It accomplishes this separation by accepting the interstate/intrastate cost allocation that is embedded in the average schedule rates. In other words, total company ratemaking bases the assignment of costs to the intrastate jurisdiction on the *same* methodology used to allocate costs and set rates on the interstate side.[18] This is not inconsistent with the *New England Telephone* decision.

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17. While this section of the decision relates only to jurisdictional issues, I discuss below whether it is appropriate to use the "total company" ratemaking methodology for Shoreham.

18. The fact that this cost allocation is different than the cost allocation included in the Proxy cost study approach, does not mean that total company ratemaking is inconsistent with the *New England Telephone* decision. Rather, it illustrates how the use of different ratemaking methodologies in the interstate and intrastate jurisdictions can lead to ratepayers paying rates that enable a company to recover more than its total costs. This is exactly the situation that total company ratemaking is intended to prevent.

(b) Other Issues

In addition to its legal argument in opposition to total company ratemaking discussed above, Shoreham argues that there are other reasons that the Board should not change its existing ratemaking methodology for average schedule companies and adopt total company ratemaking. The Company contends that such a change would significantly reduce its intrastate revenue requirement, thereby greatly destabilizing the Company and its services and creating the potential for rate shock for Shoreham's ratepayers. Using established practice and precedent, the Company maintains that its existing intrastate rates are producing intrastate revenues that are roughly equal to or slightly below its intrastate revenue requirement. Moreover, Shoreham believes that the regulatory policies proposed by the Department, including the use of total company ratemaking, are arbitrary, poorly planned and inconsistent, and will have an immediate, adverse impact on the Company's operations. Consequently, the Company believes that its existing rates are just and reasonable and should be retained.

Shoreham further argues that the Board should not adopt total company ratemaking because the radical revenues reductions proposed by the DPS will force it to abandon average schedule ratemaking and elect a traditional cost-based methodology, an outcome that would have an upward impact on its intrastate rates and a downward pressure on its interstate revenues. This might lead to a prolonged series of Board proceedings to stabilize its rates, and it might result in rate shock in the near- and middle-term. Shoreham asserts that because its rates have been consistently stable and similar to those of other ILECs in Vermont, moving to total company ratemaking would jeopardize a long-standing stable situation in exchange for possibly producing the lowest revenue-per-access line of any ILEC in Vermont.

Finally, Shoreham suggests that the DPS's proposed use of total company ratemaking presumes that the Company's actual costs will continue to be lower than the national average and the benefits of this methodology will continue to flow from the interstate side to the intrastate side. Since it is possible that the Company's costs may rise in the future because of the need for additional investments in plant and equipment, a situation may develop where Shoreham's actual interstate costs exceed the national average costs used in the average schedule. In that case, the Company argues, intrastate revenues might have to subsidize interstate operations.

The DPS asserts that under the existing ratemaking methodology Shoreham has been allowed to earn rates of return on its invested capital that significantly exceed, on a total company basis, the reasonable rates of return allowed other telephone companies. To rectify this situation, the DPS argues that the Board should adopt total company ratemaking because, in addition to lowering rates for Shoreham's customers, it will ensure that the Company does not recover more than 100 percent of its allowed revenue requirement. Also, the DPS suggests, the use of the total company methodology will allow Shoreham to continue saving ratepayers the costs associated with developing intrastate separations factors for an average schedule company that does not conduct separations studies.

The Department discounts Shoreham's suggestion that the Board should not adopt total company ratemaking because it will force the Company to elect to become a cost company. According to the DPS, any such decision is a business decision that can only be made after this rate case is concluded, and the Company's contingency plan should not be used to improperly inform or shape the justness or reasonableness of the rates to be determined by this case.

(3) Conclusion

Based on all of the evidence in this proceeding, the underlying law, and my judgment as to an equitable outcome, I recommend that the Board apply the total company ratemaking methodology to Shoreham for the purpose of determining just and reasonable rates. It is not reasonable to allow any utility company, even one that has been as well run and efficient as Shoreham, to recover significantly more than 100% of its costs, and thereby earn rates of return on its invested capital that are excessive. Use of the total company methodology will ensure that Shoreham will still be able to realize a just and reasonable rate of return on its invested capital, and continue to provide high quality services to its customers.

There is no evidence, as Shoreham suggests, that use of total company ratemaking will destabilize the Company to such an extent that its operations will be adversely affected. Such assertions were not supported in the record in any concrete way and were no more than speculation by the Company's representatives. To the contrary, the evidence suggests that Shoreham will be able to fully meet its revenue requirement and earn a fair return on its investments, even with the revenue reduction that I propose.

There is also no evidence that this Order will produce "rate shock" as suggested by the Company. Shoreham's customers will receive some significant rate reductions in the near future.[19] It is not certain, or even very likely, that Shoreham will soon thereafter have to file for rate increases that will produce rate shock. While there is some evidence that over time Shoreham's costs may rise in some areas, particularly if there is a new owner or if the company elects to become a "cost company," these would be developments that are not sufficiently known and measurable to affect this rate decision at this time. The Company always has the right to file for rate adjustments, when needed, to ensure that its rates are just and reasonable.

I realize that there can be a significant benefit to Shoreham and its customers if the Company remains an average schedule company. Consequently, I propose that the Board include some additional revenues for Shoreham that would be available to its owners if they continue to operate the Company as an average schedule company. This would provide the owners the incentive to operate as efficiently as possible so that the Company will continue to have interstate costs that are below the average schedule, an outcome that is beneficial to the owners, the ratepayers and the State. This incentive of about $100,000 per year would approximate the extra costs Shoreham would incur if it changed to a "cost company" methodology for determination of interstate costs.

C. Cost of Service

(1) Rate Base Adjustments

(a) Interim-Year Accumulated Depreciation

26. Shoreham's current rates provide for recovery of investor capital through annual depreciation expenses. Smith pf. at 20.

27. In 2003, Shoreham reported depreciation expenses that were part of Shoreham's cost of service and, thus, recovered in rates. Tr. 5/25/04 at 15 (Abbott).

28. Shoreham's original cost of service filing does not account for interim-year depreciation. Tr. 5/25/04 at 13 (Abbott); Smith pf. at 19.

29. Shoreham's interim-year accumulated depreciation balance must be increased, and the

19. The exact rate reductions will be determined by the Board in a subsequent proceeding.

net telecommunications plant in rate base reduced, by $503,955 in order to recognize 2003 depreciation expenses. Smith pf. at 19.

30. For the interim year, the average accumulated depreciation balance is $5,790,344. Smith pf. at 21.

(b) Rate Year Accumulated Depreciation

31. Depreciation expenses will be incurred during the rate year ending December 31, 2004, the year in which new rates will be in effect. Smith pf. at 22.

32. In this proceeding, Shoreham did not increase accumulated depreciation to reflect known and measurable depreciation expenses incurred during the 2004 rate year. Exh. STC-1, Sch. 2.

33. In order to downward adjust net telecommunications plant in rate base to reflect 2004 rate year depreciation expenses that will be recorded and recovered in current rates, Shoreham's accumulated depreciation balance must be increased, and the net telecommunications plant in rate base reduced, by an additional $529,975. The increase in rate year accumulated depreciation is based on 2003 regulated depreciation expenses. Smith pf. at 21-22.

34. For the rate year, the average accumulated depreciation balance is $6,320,319. Smith pf. at 23.

35. In total, Shoreham's accumulated depreciation balance will increase, and the net telecommunications plant in rate base will be reduced, by $1,033,930 after recognizing known and measurable depreciation expenses during the interim and rate years. Smith pf. at 21–23.

36. If adjustments to accumulated depreciation are not made to reflect known and measurable depreciation expenses, ratepayers pay twice for telecommunications plant in service. Smith pf. at 20.

37. The current owners of Shoreham have entered into a purchase and sales agreement. Abbott reb. pf. at 4.

38. Pursuant to the purchase and sales agreement, Shoreham made no major plant investments in 2003. Abbott reb. pf. at 4.

Discussion

Consistent with the Board's ruling in Docket No. 6596,[20] the Department relied on a two-step process to develop its recommendation to increase Shoreham's accumulated depreciation balance by $1,033,930. First, the Department increased the average interim-year accumulated depreciation balance in order to reflect known and measurable depreciation expenses that were incurred during the interim year. Second, the Department increased the average rate-year accumulated depreciation balance to reflect the known and measurable depreciation expenses that will be incurred during the rate year. The Department rests its recommendation on the 1994 Vermont Supreme Court's directive in *Green Mountain Power Corp,*[21] which states that a utility's rate base must be adjusted for interim-year depreciation expenses. In that decision, the Supreme Court stated:

> The essential reason to apply the "known and measurable change" principle to the test year rate base is that once customers have, in effect, returned a portion of a utility's investment, they should not be required to pay for that portion a second time, once as depreciation expense and again as a return on plant value which had not been correspondingly reduced to reflect the "return of" the investment through depreciation expense payments.[22]

Shoreham opposes the Department's recommendation for two reasons. First, Shoreham contends that despite the Vermont Supreme Court's 1994 directive in *Green Mountain Power Corp*, the Board recently approved a tariff filing for Citizens Energy Services Company which Shoreham claims, in essence, did not reflect known and measurable changes to Citizens' rate base for ratemaking purposes. Relying on the Board's decision in Docket 6596,[23] Shoreham asks the Board to "freeze" Shoreham's rate base at the test-year 2002 rate level.[24] According to Shoreham, freezing the rate base at 2002 levels has merit because the Board's Order in Docket 6596 allowed for "an unusual 'one-sided adjustment' whereby retirements are posted to the plant accounts without making corresponding adjustments to accumulated depreciation" for the limited

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20. *Tariff filing of Citizens Communications Co., d/b/a Citizens Energy Services,* Docket No. 6596, Final Order of July 15, 2002, at 59–62 ("*Citizens").*
21. *In Re: Green Mountain Power Corp.*, 162 Vt. 378,382 (1994).
22. *Id.* at 384.
23. Shoreham Reply Brief at 11; *see* also *Citizens* at 51.
24. Shoreham Reply Brief at 11.

purpose of setting rates.[25]

In Shoreham's second argument, the Company asserts that the Department's recommendation is inequitable and one-sided because the Department did not consider any off-setting adjustments such as plant additions or retirements.[26] Shoreham maintains that lowering the net investment from Shoreham's proposed $3,094,639 to the Department's proposed net rate base of $2,048,734[27] is not representative of Company operations and does not reflect a reasonable level of investment that is necessary to provide service.[28] Under this reasoning, Shoreham asserts that if the Board adopts the Department's recommendation, Shoreham is "entitled" to calculate an offsetting average amount of net plant investment for the post-test year and the rate year.[29]

I concur with the Department's recommendation. The Department has correctly noted that the Vermont Supreme Court's decision in *Green Mountain Power Corp.* requires a utility's rate base to be adjusted for interim-year depreciation. Similarly, as the Board expressly ruled in *Citizens*, it is appropriate and consistent with Board precedent to also adjust a utility's rate base for rate-year depreciation expenses.[30] In the instant case, both parties acknowledged that current rates include a provision for depreciation expenses and that Shoreham's accumulated depreciation balances increased in 2003.[31] Additionally, the Department asserts that accumulated depreciation will increase in 2004.[32] Shoreham also stated that it made no new plant investments in 2003 and 2004 that would have the effect of increasing its rate base.[33] Both parties also acknowledge that, for the purpose of setting rates, Shoreham's cost of service filing did not reflect known and measurable changes to its rate base to reflect increases in accumulated depreciation balances.[34]

When faced with the undisputed evidence that depreciation expenses are being incurred,

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25. *Id.*; *Citizens* at 51.
26. *Id.*
27. After adjustments to reflect materials and supplies, cash working capital and accumulated deferred income Taxes.
28. Abbot reb. pf. at 5.
29. Shoreham Reply Brief at 12.
30. *Citizens* at 61.
31. Smith pf. at 20; tr. 5/25/04 at 15, 16 (Abbott).
32. Smith pf. at 22-23.
33. Abbott pf. at 4.
34. Tr. 5/25/04 at 16 (Abbott);Smith pf. at 19, 22.

and a clear mandate to adjust rate base for known and measurable changes to accumulated depreciation, the Board does not have the discretion to approve Shoreham's request to freeze its rate base at 2002 test-year levels. Even though I recognize that Shoreham has not made new plant investments due to the restrictions in its sales agreement, I cannot recommend that the Board issue an order that would be inconsistent with the Vermont Supreme Court's 1994 decision. Furthermore, Shoreham's request to freeze its rate base at 2002 test-year levels would allow investors to over-recover their investment in plant, and result in ratepayers paying twice for the assets placed in service. This would be an unjust and unreasonable result.

Irrespective of the Vermont Supreme Court's 1994 decision, Shoreham contends that the Board did allow for an "unusual, one-sided adjustment" in Docket No. 6596. Based on that decision, Shoreham contends that its request to freeze the rate base at 2002 test-year levels in this case is justified. However, Shoreham has mis-characterized the Board's decision on accumulated depreciation. The Board's Order in Docket No. 6596 states:

> Citizens' tariff filing reflects an agreement in principle between Citizens and the Department regarding the MRI Audits and appropriate T&D plant account balances and depreciation reserves. This settlement includes an unusual "one-sided adjustment" whereby retirements are posted to the plant accounts without making corresponding adjustments to accumulated depreciation. The settlement has not yet been filed with the Board, so the Board has not yet had an opportunity to review the settlement in its entirety. Nevertheless, we will accept the "one-sided adjustment" agreed to in the settlement for the limited purpose of setting rates in this docket. We will consider the settlement in its entirety once it is filed in Docket Nos. 5841/5859, and our decision here should not be considered precedential with respect to those dockets.[35]

A plain reading of the Board's discussion bears no relationship to the assertions Shoreham attempts to make. Rather than allow Citizens Communications Company to freeze its rate base at a given point in time, the Board's Order had the effect of reducing the net plant in service. As stated above, plant retirements reduce the amount of rate base (assuming all other elements are held constant) by the value of the installed cost of an asset. Increases in accumulated depreciation also reduce the value of the installed cost by the amount of the depreciation expense incurred each year. Typically, when a company recognizes the retirement of an asset, it also removes from its balance sheet the accumulated depreciation associated with that asset. In this

35. *Citizens* at 51.

way, the net value of all assets changes by the relative difference between the installed cost of a retired asset and its accumulated depreciation. If plant retirements are recognized but accumulated depreciation is not, as was the case in Docket No. 6596, the rate base (assuming again that all other elements are held constant) would be reduced by an amount that is roughly twice the amount that it would ordinarily be reduced. The Board's acceptance of the one-sided adjustment in Docket No. 6596 is unusual, but it does not support Shoreham's contention that a Board order to freeze its rate base at the 2002 test-year level is just.

Regarding Shoreham's second argument, the Company asserts that if the Board adopts the Department's recommendation, it is "entitled," pursuant to a 1998 Order in Docket No. 5983, to be able to calculate an offsetting average amount of net plant investment for the interim-year and rate year. According to Shoreham, if the Board were to issue an order similar to that which it issued in Docket No. 5983, a post-judgment compliance filing would mitigate the one-sided adjustment advanced by the Department. Shoreham contends that its post-judgment filing would result in an average net plant investment, Company-wide, of $3,362,846, based on a five-year historical average.[36] Once again, Shoreham mis-characterizes a Board order.

It is true that the Board ordered Green Mountain Power Corporation ("GMP") to submit a compliance filing in Docket No. 5983. The filing, however, served a limited purpose: to capture a more complete picture of the impact of GMP's plant retirements and associated accumulated depreciation on the Company's total plant in service. It was not intended to represent a Board policy that allowed utilities to average net plant in service over a five-year period, as Shoreham implies.

In Docket No. 5983, GMP originally neglected to remove retirements from its plant-in-service records. To remedy this oversight, both GMP and the Department agreed that an adjustment was necessary as plant retirements represent a known and measurable change that is to be included in rate base calculations. The Department recommended the use of a five-year average of plant retirements as a reasonable estimate rather than identify specific plant retirements. Because the Department did not have the information necessary to make the corresponding adjustment to accumulated depreciation, it recommended that GMP be ordered to

36. Shoreham Reply Brief at 12; exh. STC-4.

make a compliance filing on this narrow issue. The Board agreed. Accordingly, GMP made a filing that calculated a five-year average of plant retirements and associated accumulated depreciation. In the GMP case, the Board merely concurred with the Department's recommendation on this case-specific issue due to its soundness and because the parties were in agreement. Nowhere in the Board's GMP order does the Board actually depart from its existing policy of establishing a rate base as of a specific point in time. Nor does the Board state that the use of a five-year average net plant in service (as opposed to a five-year average of plant retirements and associated accumulated depreciation) is reasonable for the purpose of setting rates. Thus, the Board's Order in Docket No. 5983 cannot be construed as the entitlement that Shoreham implies in its brief. The Board's policy has been consistent over the years.

During the course of the instant investigation, Shoreham had ample time to compile a list of plant retirements. The Company had the time to present evidence that a five-year average of plant retirements and associated accumulated depreciation would be more representative of the Company's overall rate base. It chose not to make such a filing. As the record evidence now stands, Shoreham's rate base reflects the net value of plant in service as of the end of the 2002 test year plus the known and measurable changes recommended by the Department. Therefore, based on the record evidence, coupled with the soundness of the Department's analysis and its consistency with past Board rulings, I find the Department's adjustment of $1,033,930 results in a more accurate reflection of the current value of Shoreham's accumulated depreciation.

(2) Capitalized Labor

39. Shoreham's cost of service filing includes a labor adjustment to increase its 2002 test-year rate base by $12,529 in order to capitalize a portion of its salary expense. Smith pf. at 19.

40. The Department's cost of service filing reversed Shoreham's capitalized labor adjustment because it double counts Shoreham's proposed payroll expense (i.e., the payroll expense proposed by Shoreham was not reduced to reflect this capitalized amount). Smith pf. 19; tr. 5/25/04 at 201 (Smith) and tr. 5/26/04 at 23 (Smith).

41. Shoreham had no work orders to support the amount of capitalized labor in question. Tr. 5/25/04 at 19 (Abbott).

42. Shoreham has neither explained nor justified what plant is being added to rate base in its pro forma payroll capitalization adjustment. Smith reb. pf. at 13; tr. 5/25/04 at 201 (Smith).

43. There were no known and measurable plant changes proposed by the Company in 2003. Tr. 5/25/04 at 202 (Smith).

Discussion

Shoreham has failed to provide an evidentiary basis to support its proposed capitalized labor adjustment. Absent documentation or testimony that explains the reason for capitalizing this labor and specific identification of the plant to which it relates, I am left with no evidentiary support to conclude that there is a proper reason to allow this capitalization. The "known and measurable" standard is not met when an addition to plant cannot be identified or connected to supporting documentation such as a work order; nor is the standard met when documentation or testimony is lacking to show that the plant increase is not due to volume or growth-related changes. Moreover, as pointed out by the Department, the Company did not reduce its payroll expense adjustment to reflect the capitalized labor addition to rate base. I, therefore, find the Department's position is appropriate and recommend reversing Shoreham's proposed rate base increase in the amount of $12,539.

(3) Cash Working Capital

44. Shoreham's cost of service filing includes a $233,235 Cash Working Capital rate base allowance that it developed using a 12.5% factor[37] that assumes a net revenue lag of 45 days. Exh. STC-1, Schedule 2; Abbott reb. pf. at 6.

45. The use of a 45-day net revenue lag is based on a formula that is contained within the 2003 State of Vermont Annual Report that is filed with the Department and the Board. This formula was used by other incumbent local exchange carriers in Vermont in 2003. Exh. Board-1; Abbot reb. pf. at 6.

46. In the absence of a lead-lag study to support a 45-day Cash Working Capital requirement, the Department presumes there is no need for a Cash Working Capital allowance

37. The 12.5% factor is determined by dividing 45 days by 365.

and completely deleted Shoreham's $233,235 Cash Working Capital from rate base in its cost of service filing. Smith pf. at 31-33.

47. An intrastate lead-lag study could cost $15,000 to $20,000 and would become part of the intrastate rate-case costs included in intrastate rates. Tr. 5/25/04 at 213 (Smith).

48. 62% of Shoreham's total revenues are billed in arrears. Tr. 5/25/04 at 211-212 (Smith).

49. Shoreham bills its customers on the first day of the month, with payment due 30 days later. Exh. STC-5.

50. The customer bill includes measured service and other charges for the prior month, with payment for those charges also being due on the last day of the month in which the bill is sent, thus creating approximately a 45-day lag for those payments. Abbott reb. pf. at 6.

51. Shoreham typically pays its own bills within 15 days of receipt of invoice. Abbott reb. pf. at 6.

Discussion

The intent of a Cash Working Capital allowance is to provide the utility with a return on the amount of funds legitimately used to sustain daily operations. This investment is a result of any delay in the time between the deposit of customer payments for monthly service in the utility's bank account and the due dates of its monthly bills. If it is proven that there is a need for an investment of company funds for this purpose, then the utility incurs a known and recurring cost of service (*i.e.*, the opportunity cost of the funds invested to cover the lag in service revenue and monthly payments) that must be recovered in rates.

In the absence of a lead-lag study, the Department recommended that Shoreham's Cash Working Capital allowance should be eliminated. It supported its contention by presenting examples of cases where a local telephone carrier elected not to carry a positive Cash Working Capital allowance in its rate base.[38] In another example, the Department presented documentation that appeared to be excerpts of prefiled testimony in a US West (now Qwest) rate case recommending that the carrier's rate base be reduced as a result of a lead-lag study indicating

38. Smith pf. direct at 34-35; exh. DPS-7, attachment 8.

a negative Cash Working Capital requirement.[39] While these examples are instructive, they cannot be directly applied to Shoreham's situation because every local exchange company ("LEC") has different billing and payment practices that affect its need for a Cash Working Capital allowance.

On rebuttal, Shoreham presented evidence that a substantial lag exists between the time it receives payment for 62% of its total revenues and the time it issues payments to sustain operations and pay employees. Therefore, I recommend that the Board allow Shoreham to include a Cash Working Capital allowance in rate base.

It is unclear from the record evidence, however, exactly what factor would be representative of Shoreham's investment requirements in Cash Working Capital. The Department is correct that Shoreham has not conducted a lead-lag study as the Department argues is necessary for calculation of a Cash Working Capital allowance. Nevertheless, given the high cost of such a study and the existence of the 45-day proxy that is used by the Department in its annual report form to evaluate the rate base needs of other Vermont LECs,[40] I do not believe that it is reasonable to require the Company to undertake such a study at this time. Instead, I recommend that the 45-day lag factor be used for Shoreham.[41]

(4) Customer Deposits

52. Customer deposits represent funds provided to the Company by customers for the provision of services. Smith sur. pf. at 8.

53. Shoreham has a funded cash account, Account 114000-100, in its General Ledger called "Cash - Customer Deposits," which exceeds the liability to customers for their deposits. Abbott reb. pf. at 7.

54. Shoreham segregates these customer deposit funds from the Company's other cash. This practice effectively restricts the use of this cash and the funds are not used for any other purpose. Abbott reb. pf. at 7.

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39. *Id.*, attachment 9.

40. Exh. Board-1.

41. I note that if the Department believes that the use of this factor by Vermont LECs is unreasonable, its remedy for future cases is to change the factor in the 2004 annual report form that will be issued in the winter of 2005 and require LECs to file support for a 45-day Cash Working Capital allowance.

55. If Shoreham maintains a fully funded, separate bank account designated solely for the purpose of paying for customer deposits, the Department agrees that Shoreham's inclusion of $15,070 of average customer deposits is a known and measurable change to rate base. Smith reb. pf. at 8.

Discussion

Shoreham argues no rate base deduction for customer deposits should be taken because Shoreham keeps a cash account in which such deposits are held separately. According to Shoreham's witness, the purpose of this practice is to protect customer cash; the practice in effect restricts Shoreham's use of the customer deposit funds.

The Department maintains that customer deposits should be deducted from Shoreham's rate base. The recommended adjustment is $15,070, an amount representing the average of the December 31, 2001, and December 31, 2002, balances from Shoreham's audited 2002 financial statements.

The Department's witness testified that if Shoreham could prove that it has a funded bank account specifically for customer deposits and the registration on such bank account was such that the money could not be used for any purposes other than paying customer deposits, then the Department's witness would agree that customer deposits under those circumstances should not be deducted from rate base.[42] While the Department maintains that no such showing was made, the Company has testified that funds are kept in a separate account and are, in fact, used for no other purpose.[43] Consequently, I am persuaded that the Company's procedures to protect these funds are adequate and appropriate. Therefore, Shoreham's rate base should not be reduced by the amount recommended by the Department.

(5) Allocation of General Support Assets to Non-Regulated Activities

56. General Support Facilities ("GSF") include land, buildings, vehicles, furniture, office equipment, computers and other similar assets that are used by Shoreham to provide regulated and non-regulated services. Smith pf. at 24–25.

57. Shoreham provides services such as internet connectivity, customer premise equipment

42. Smith sur. pf. at 8.

43. Abbott reb. pf. at 7; tr. 5/25/04 at 93 (Abbott).

and long distance toll resale on a non-regulated basis. Smith pf. at 25–26.

58. For the purposes of ratemaking, Shoreham is required to separate regulated costs from non-regulated costs by removing the net value of non-regulated assets from the Company's total rate base. Smith pf. at 24-25; exh. DPS-7; 47 C.F.R. Part 64.

59. Shoreham did not remove from its rate base a portion of its total assets jointly used for the provision of non-regulated services. Smith pf. at 25.

60. An indirect allocator of 7.4% should be used to separate the net value of total assets that are jointly used for the provision of regulated and non-regulated services. Smith pf. at 29.

61. Based on its analysis of directly assigned payroll expenses charged to non-regulated activities, the Department's filing reduced Shoreham's regulated rate base by a net amount of $15,823. Smith pf. at 30.

Discussion

47 C.F.R. Part 64 requires carriers to separate total regulated costs from total non-regulated costs. Where such costs cannot be directly separated, 47 C.F.R. Part 64 provides carriers with specific guidelines on how to indirectly separate these costs. Shoreham's total GSF assets were partially used in the provision of non-regulated services but were not separated from regulated services by Shoreham for the purpose of setting rates. As a result, the Department asserts that Shoreham is not in compliance with the FCC's regulations.

I concur with the Department. The Board has consistently ruled that costs are to be separated between regulated and non-regulated services in a manner that is consistent with 47 C.F.R. Part 64.

Following the FCC's guidelines, the Department developed an indirect allocator of 7.4%[44] and applied it against the value of GSF in rate base, resulting in a recommended net reduction of $15,823.

Shoreham agrees with the Department's 7.4% allocator but asserts that the Department applied the allocator too broadly. Shoreham asserts on rebuttal that certain GSF assets were not

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44. The indirect allocator is based on the Department's analysis of directly assigned labor costs to non-regulated activities in conformance with 47 C.F.R. Part 64.901(b)(3)(ii). Smith pf. at 28.

used in the provision of non-regulated service.[45] Accordingly, Shoreham states that only $7,588 in total Company rate base costs should be removed from Shoreham's original cost of service filing rather than the Department's net reduction of $15,823.

I find Shoreham's assertions to be unsupported by the record evidence. Exhibit STC-7 purportedly identifies assets such as vehicles, computers and portions of buildings that were not used in the provision of non-regulated services. The list of assets identified in Exhibit STC-7, however, does not support Shoreham's proposed reduction to the Department's recommendation. For example, the list does not adequately explain why the identified assets are not jointly-used between regulated and non-regulated services. Also, Shoreham claims that vehicles were not used in the provision of non-regulated services even though the weight of the evidence indicates that vehicles were being used for both regulated and non-regulated services.[46] In each instance, Shoreham did not provide any supporting detail, nor explain why its recommendation would comply with FCC regulations. The Company failed to provide a basis for approval or indicate why its recommendation was a more accurate reflection of the costs that should be separated between regulated and non-regulated services. For these reasons, Shoreham's recommendation to reduce the Department's adjustment is denied. Similarly, I find the Department's recommendation to be a better reflection of Shoreham's actual cost of providing regulated services and prevents ratepayers from subsidizing non-regulated services.

(6) Accumulated Deferred Income Tax

62. Accumulated Deferred Income Taxes ("ADIT") represent the amount of cost-free capital provided by customers through rates to pay for anticipated income taxes that have been deferred. Smith pf. at 36.

63. Differences in the amount of actual income taxes paid and the amount of income taxes deferred to a future period arise due to the difference in the recognition of revenues and expenses for ratemaking purposes and income tax purposes. Smith pf. at 36; Gurley reb. pf. at 6; tr. 5/27/04 at 23-24.

64. Shoreham's cost of service filing in this case reflects a rate base deduction for ADIT of

45. Abbott reb. pf. at 13-14; exh. STC-7.
46. Tr. 5/27/04 at 121.

$611,143 which was based on Shoreham's historical application of the C-Corporation income tax rate for ratemaking purposes. Exh.-STC-1, Sch. 2 and Sch. 4.

65. The balance in Shoreham's ADIT account represents customer funds that were paid prior to December 31, 2002, for future anticipated income tax obligations. Smith pf. at 37; Smith reb. pf. at 24.

66. Shoreham does not pay income taxes but reimburses the shareholders for their personal income tax obligation. Tr. 5/27/04 (Gurley) at 22. (*See* also, the section below on Income Tax expenses).

Discussion

ADIT represents cost-free funds provided by ratepayers to pay for future tax obligations. The parties agree that Shoreham's rate base should be reduced by the amount of the ADIT. The parties also agree that Shoreham's allowed income tax expense necessarily informs the amount of Shoreham's ADIT rate base deduction, and if the Board rules that Shoreham's income tax expense should be based on the personal income tax rate (see the income tax expense section below for more detail), this decision will affect Shoreham's rate base. They do, however, have different proposals as to how Shoreham's rate base should be affected by such a decision.

Shoreham argues that if the Board reduces annual tax expenses to reflect personal income tax rates, then the current ADIT balance should be recalculated based on the new tax rates.[47] Although Shoreham did not provide an alternative ADIT balance using lower tax rates, Shoreham asserts that such a recalculation is necessary to comply with Generally Accepted Accounting Principles ("GAAP") which, according to Shoreham, require income tax expenses and deferred income tax liabilities to be calculated at the same tax rate the taxpayer is "expected" to pay.[48]

The Department argues that it is not necessary to recalculate Shoreham's ADIT balance using the lower tax rates as Shoreham proposed. Instead, the DPS recommends reducing the

47. Shoreham has been accumulating deferred income tax liabilities as if it had been taxed at the C-Corporation rate. *See*, Re: Investigation into the existing rates of Shoreham Telephone Company, Inc., Docket No. 6401, Order of 2/21/01.

48. Shoreham Reply Brief at 11.

existing ADIT by amortizing the excess balance that is due to the differences in the C-Corporation income tax rate and the lower personal income tax rate, thereby ensuring that any reductions flow back to ratepayers. The Department did not provide documentation on the effect this proposal would have on rates other than to state that such an amortization would reduce expenses and decrease the revenue requirement.[49]

After carefully reviewing the evidence on this issue, it is clear that the parties agree that Shoreham's ADIT balance should be reduced to reflect the change in income tax rates,[50] but disagree on how this reduction should be accomplished and on what should happen to the excess funds. Under Shoreham's proposal, the ADIT balance would be recalculated immediately, and the Company would keep the excess funds. In contrast, under the DPS's proposal, the ADIT balance would be gradually reduced over time and ratepayers would receive the excess funds.

Shoreham states that FASB Statement of Accounting Standard 109 "requires that book and tax balance sheets of a company be compared, and the deferred tax liability be computed on the results of that comparison, given the tax rate that a taxpayer is expected to pay."[51] Shoreham argues that using different tax rates for tax expense and deferred income taxes is not consistent with this standard. Shoreham has not adequately explained how FASB 109 applies to this situation. Nevertheless, consistent with basic accounting principles, I am persuaded that, regardless of the applicability of FASB Standard 109 to Shoreham, consistency between the calculations of tax expense and deferred income taxes for ratemaking purposes is important. Therefore, I recommend that the Board require Shoreham's ADIT to be recalculated if the Board changes Shoreham's tax rate for ratemaking purposes.

However, the DPS has persuaded me that the existing ADIT balance consists of ratepayer funds. That is, ratepayers have funded the ADIT balance by pre-paying Shoreham's expected future income taxes (or perhaps, more accurately, the estimate of expected future income taxes that was used for ratemaking purposes). If the estimate of Shoreham's expected future income taxes is changed for ratemaking purposes, the "excess" funds paid by ratepayers should be

49. DPS Brief at 46-47.

50. The DPS has not explicitly stated that the ADIT balance should be reduced. However, the DPS has proposed a mechanism for reducing the ADIT balance. Therefore, I conclude that the DPS agrees that it is appropriate to reduce the ADIT balance.

51. Shoreham Reply Brief at 11.

credited to them. The DPS has proposed a mechanism for doing so — amortizing the excess funds over a period of time. I conclude that this approach is reasonable. Ratepayers contributed the funds over a period of time, with the expectation that the Company would use the funds over a future period of time. The Department's proposal to amortize these funds better approximates the time period over which the funds were originally expected to be used, thereby mitigating the cash flow impact on the Company while still ensuring that the funds are applied ultimately for the benefit of ratepayers. Therefore, I recommend that the Board require Shoreham to recognize a regulatory liability equal to the reduction in its ADIT, and to amortize this liability over a period of time.

There is no evidence in this Docket regarding how much Shoreham's ADIT should be reduced if the Board changes Shoreham's tax rate for ratemaking purposes, or what an appropriate amortization period for the new regulatory liability account might be. To address this deficiency, I recommend that the Board require Shoreham to make a compliance filing, within 45 days of the date of this Order, showing the recalculated ADIT and proposing an amortization period. I recommend that the Board require any party who wishes to comment on Shoreham's compliance filing to do so within 30 days of the Company's filing. Finally, I recommend that the Board incorporate its decisions regarding the new regulatory liability account's amount and amortization period into its final determination regarding Shoreham's revenue requirement.

D. Revenue Adjustments

(1) Local Measured Service

67. Shoreham's Local Measured Service ("LMS") revenue declined in 2003 by $7,000. Shoreham expects a continuing downward trend in LMS revenue as a result of decreasing demand for second lines. Abbott reb. pf. at 8.

Discussion

The Department argues in this proceeding that Shoreham's LMS revenue should not be reduced because the Company's assertions about declining LMS revenues are based on a perceived trend and are, therefore, unsubstantiated.[52] I disagree. Shoreham experienced a decline in LMS revenues during 2003 that is known and measurable, and there is credible evidence that LMS revenue will not rebound given the Company's declining number of second lines. Consequently, I find Shoreham's proposed $7,000 revenue adjustment to be a known and measurable change for the purpose of setting rates.

(2) Federal High Cost Loop Support

68. Shoreham removed 25% of the federal loop support it received from its intrastate revenue stream on the grounds that is related to interstate traffic. Exh. STC-1, Sch. 6.

69. It is a well-established industry practice to earmark 100% of the federal high-cost loop support for intrastate costs. Smith reb. pf. at 10.

70. To properly calculate revenues on a total company basis, it is necessary to consider all revenues related to the provision of regulated telephone service. Smith pf. at 39.

71. In 2003, all other Vermont Incumbent LECs that received this type of federal support allocated 100% of the funds to their intrastate accounts. 2003 Vermont Annual Reports of Incumbent Telephone Companies.[53]

Discussion

In this proceeding, I recommend the Board set intrastate rates in accordance with the total company methodology outlined above. If the Board accepts this methodology and sets rates on a total company basis, then this contested issue is moot. As described above, all revenues are initially combined to determine Shoreham's total company revenue requirement, interstate revenues are then subtracted from the total revenue requirement, and the remainder is Shoreham's intrastate revenue requirement. Thus, the allocation of this revenue stream, as proposed by Shoreham in its cost of service filing, is irrelevant. If, however, the Board opts to set rates based on past methodologies, then I would find Shoreham's adjustment to be unjustified. In 2003, all other Vermont Incumbent LECs that received this type of federal support allocated 100% of the

52. Smith pf. at 38; Department Initial Brief at 23.

53. The parties did not object to the Board taking judicial notice of these reports. Tr. 5/25/04 at 74.

funds to their intrastate accounts.[54]

(3) Universal Service Support

72. Shoreham received $729,037 of federal Universal Service Fund ("USF") revenue for high-cost loop support, long-term support and local switching support in 2002. Smith pf. at 40; exh. DPS-6, Attachment 10.

73. The Company's present annualized amount of high-cost support is $967,968. Smith pf. at 42; exh. DPS-6, Schedule C-3.

Discussion

Federal USF revenue is intended to support the provision of universal telephone service throughout rural America. For the 2002 test year, Shoreham received $729,037 of federal USF revenue for high-cost loop support, long-term support and local switching support. Shoreham's federal USF revenue should be reflected in the determination of the total company revenue requirement in this proceeding, and, indeed, Shoreham's cost of service filing reflects the total USF revenue it received for the 2002 test year. However, the test year recorded amount used by Shoreham in its cost of service filing does not reflect the known, current amounts being received.

The most current data available shows that Shoreham is receiving $967,968 in high-cost support on an annualized basis. As calculated by the Department, the difference between Shoreham's 2002 test year figure and the most recent, annualized figure is $238,931.

Shoreham did not rebut the Department on this issue. I recommend that the Board adopt the Department's adjustment.

(4) Uncollectible Revenues

74. Shoreham reported $34,715 in uncollectible revenue in the test year. Exh. STC-1, Sch. 4.

75. This amount is more than double the highest year (2000) for which comparable information was available to the Department, and it is 11.5 times greater than Shoreham's 1999 recorded uncollectibles amount of $2,762. Smith pf. at 42.

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54. Vermont 2003 Annual Reports.

76. Shoreham's 2002 uncollectible revenue included $25,885 in carrier bad debt, of which $22,135 is related to the WorldCom bankruptcy and $3,751 is related to the Global Crossing bankruptcy. Smith pf. at 43; exh. DPS-7, Attachment 12.

Discussion

Utilities typically experience difficulties collecting a small portion of their annual revenues. The issue in this case is what percentage of Shoreham's revenues are deemed to be uncollectible on an annual basis. Once that is established, then the amount of that revenue that is normally uncollected and recognized as a bad debt expense is considered a known and measurable cost.

The Department recommended revising Shoreham's $34,715 of uncollectible debt downward by $24,327 on the basis that a three-year average of uncollectible revenues is more reflective of Shoreham's past experience.[55] The Department stated that Shoreham's cost of service filing included an abnormally high rate of uncollected revenues that would not normally be incurred on a going-forward basis.[56] The higher rate is mostly because of the bankruptcies of WorldCom and Global Crossing, two large interexchange carriers. On a going-forward basis, according to the Department, Shoreham will likely recognize on average $10,388 annually in uncollectible revenues that should be recovered from the general body of ratepayers. Adopting this recommendation would, however, deny Shoreham the opportunity to recoup the $25,885 currently owed by Worldcom and Global Crossing. The bankruptcies of these carriers could not have been foreseen by Shoreham's management and therefore were beyond their control. Shoreham should be allowed to recover the $25,885 in bad debt associated with these two carriers.

Nevertheless, unlike normally recurring bad debt expenses associated with retail services, the bankruptcies of large interexchange carriers are not typical. Thus, Shoreham's proposal to include the full amount of its 2002 test year bad debt expense would not be representative of its recurring costs. Instead, I recommend that Shoreham amortize the $25,885 balance in carrier bad debt over a three-year period, and include recurring bad debt expenses of $8,830 (the difference

55. Exh. DPS-6, Schedule C-4.

56. Smith pf. at 42.

between $34,715 in total bad debts and $25,885) as a known and measurable change for the purpose of setting rates.

E. Expense Adjustments

(1) Payroll and Benefit Expenses

77. Shoreham has proposed significant increases in officer salaries. These increases will bring executive salaries up to levels similar to those of executives of similarly-sized ILECs, with similar responsibilities and experience as the current executives/owners of Shoreham. Tr. 5/25/04 at 50 (Abbott).

78. Shoreham's 2003 corporate overhead expenses, which include for the most part executive salary and benefit expenses, are reasonable when compared to other Vermont ILEC's corporate overhead expenses, on a per-line basis:

2003 Corporate Overhead Expenses per Access line	
Topsham Telephone Co.	$215
Waitsfield Telephone Co.	$201
Northland Telephone Co.	$165
Franklin Telephone Co.	$161
Northfield Telephone Co.	$151
Ludlow Telephone Co.	$126
Perkinsville Telephone Co.	$126
Shoreham Telephone Co.	$122
Vermont Telephone Co.	$99

Exh. Board-1; 2003 Vermont Annual Reports.

79. Even after including Shoreham's proposed executive salary increases, Shoreham's corporate overhead expenses will still be within the range of reasonableness. Exh. Board-1; 2003 Vermont Annual Reports.

80. It is appropriate for a company's payroll and benefit expenses to include overtime pay or "as-needed" payments to individual contract workers which are commonly incurred on a regular basis. Abbott reb. pf. at 9.

Discussion

Shoreham has proposed a $109,999 increase to its revised 2002 test-year payroll expense of $606,602. This increase is due primarily to significant increases in officer salaries. Shoreham asserts that the increases in executive salaries are prudently incurred costs because they elevate the salaries to a level comparable to those of executives of similarly-sized ILECs, with similar responsibilities and experience as the current executives of Shoreham. The Department, on the other hand, has proposed only modest wage increases for both the 2003 interim year and the 2004 rate year.

I am persuaded that Shoreham's salary increase proposal is reasonable. As shown in Finding No. 79 above, in 2003 Shoreham's corporate overhead expenses were well within the range of Vermont ILECs' corporate overhead expenses, on a per-line basis. Even after the proposed salary increases, Shoreham's corporate overhead expenses will increase to approximately $150 per access line, still within the range of reasonableness.[57]

I also agree with Shoreham that the Department should not have ignored overtime costs in its adjustments. Neglecting to include these costs would either deny Shoreham the opportunity to recover its expected costs of doing business, or it could result in a deterioration of service quality if Shoreham found it necessary to scale back its workforce.

Based on all of the above, I recommend that the Board find that Shoreham's revised pro forma payroll and benefits expenses of $770,601 are appropriate.[58]

(2) Pole Rental

81. Shoreham has been accruing liabilities for unpaid and disputed pole rental bills from Central Vermont Public Service Corporation ("CVPS") dating back to 1971. Smith pf. at 48; Smith reb. pf. at 14.

82. Shoreham's 2002 test-year pole rental expense was reduced by the DPS by a net amount

57. Derived by adding 2003 Corporate Overhead expenses per line of $122 and the 2004 proposed incremental pay increase for executives and a corporate employee (compare Confidential exh. DPS-8,2:27B to Confidential exh. STC-6).

58. This is a $1,658 reduction to the Company's original cost of service filing, which Shoreham agreed was appropriate in its rebuttal testimony. Abbott pf. reb. at 10.

of $143,452 for the purpose of setting rates. Exh. STC -1, Sch. 3; exh. DPS-5, Sch. C.

83. CVPS currently bills Shoreham for the use of its poles at a rate of $15.90 per pole despite having a pending tariff rate of $21.12 per pole that has been conditionally approved by the Board pending a resolution in Docket No. 6605. At the $15.90 per pole rate, Shoreham's recurring pole rental expense is $49,498. Abbot reb. pf. at 12; exh. STC-1, Sch. 6.5.

84. Shoreham paid a rate of $7.00 per pole for 2003 and states that it will continue to pay such a rate while continuing to negotiate with CVPS. Exh. STC-1, Schedule 6.5; Smith reb. pf. at 14.

85. Shoreham does not have any written or verbal lease or pole rental agreements with any parties. Smith pf. at 49.

Discussion

On a going-forward basis, Shoreham asserts a pole rental expense of $15.90 per pole is known and measurable, even though CVPS has a pending tariff rate of $21.12. The total amount of proposed rental expense for ratemaking purposes is $49,498.

The Department recommends a pole rental expense of $7.00 per pole based on Shoreham's unaudited 2003 trial balance and CVPS invoices that indicate Shoreham has crossed out the $15.90 rate and inserted its own $7.00 per pole rate. The total amount of rental expense proposed by the Department is $17,010.[59]

Because CVPS has been billing Shoreham at a rate of $15.90 per pole, I find the $49,498 annual expense to be a known and measurable expense that should be included in rates. This finding is reasonable, even though Shoreham has actually been paying only $7.00 per pole for a number of years. The fact that CVPS has a pending tariff rate of $21.12 per pole leads me to conclude that Shoreham's future pole rental expenses are likely to increase, not remain the same, as the Department suggests.

(3) General Support Facilities

86. For the purpose of ratemaking, Shoreham is required to separate total general support

59. Exh. DPS-6, Sch. C-7; Smith reb. pf. at 15.

facility ("GSF") expenses into regulated and non-regulated expense categories. Smith pf. at 49.

87. It is appropriate to use a 7.5% indirect allocator to separate regulated and non-regulated GSF expenses. This is the same indirect allocator that was used to determine the net value of non-regulated assets that should be removed from Shoreham's rate base. Smith pf. at 29, 30 and 49.

Discussion

The Department has proposed an $11,388 reduction to Shoreham's GSF expenses to reflect the separation of regulated and non-regulated expenses. Shoreham has not contested this adjustment. As there is no dispute among the parties, I find the Department's $11,388 reduction to be an appropriate adjustment to the operating expenses of Shoreham's regulated business.

(4) Re-allocation of a portion of Depreciation Expense to Non-Regulated Activities

88. The depreciation associated with Shoreham's GSF must be allocated between regulated and non-regulated operations. Smith pf. at 50.

89. It is appropriate to use a 7.4 percent allocation factor to determine the amount of GSF depreciation that is associated with non-regulated activities. This is the same allocation factor that is used for the purpose of determining the amount of GSF plant that should be removed from rate base. Smith pf. at 29, 30, 49 and 50.

90. Company vehicles that are provided to officers with management and supervisory responsibilities over a company's regulated and non-regulated operations are subject to the joint-use property allocation between regulated and non-regulated operations. The garage facilities where such joint-use vehicles are housed or parked are also subject to the joint-use property allocation. 47 C.F.R. Part 64 (2004).

91. Shoreham's Vice President and General Manager, James Arnold, has management and supervisory responsibilities over Shoreham's regulated and non-regulated operations. Tr. 5/25/04 at 50 (Arnold).

92. Shoreham's Vice President and General Manager uses a Shoreham vehicle when conducting Shoreham business. Tr. 5/27/04 at 121 (Arnold).

Discussion

Shoreham's cost of service filing does not include an allocation to non-regulated operations for depreciation related to GSF, but such an allocation is needed. The Department applied the 7.4 percent indirect allocation factor to the $169,350 annual GSF depreciation expense, and calculated that GSF depreciation expense should be reduced by $12,532.

Shoreham asserts that the Department, in computing its proposed adjustment, has double-counted and over-depreciated Shoreham's plant. In addition, Shoreham maintains that its vehicles are not jointly used for regulated and non-regulated activities.

I find the weight of the record evidence to be against both of Shoreham's claims. Shoreham maintains that the Department's adjustment for depreciation needs to be removed because it is improperly calculated and improperly assumes that Shoreham's vehicles are jointly used.[60] Mr. Abbott contends that the treatment of depreciation on DPS-6, Schedule B-2 reduces the net GSF plant balance to $146,326, yet the computation on DPS-6 Schedule C-9 uses $169,350 of depreciation to determine the allocation to non-regulated activities, which he then states over-depreciates the entire plant.[61] Because the $169,350 GSF depreciation expense used on Exhibit DPS-6, Schedule C-9, is identical to the $169,350 annual depreciation amount for GSF that was used on Exhibit DPS-6 to calculate the adjustment to accumulated depreciation, the Department calculations are internally consistent. Consequently, there is no double-count and no over-depreciation.

Mr. Abbott's apparent assumption that Shoreham company vehicles are entirely exempt from all joint use is contradicted by the verbal testimony of Shoreham's Vice President. Shoreham vehicles that are provided to officers such as the Company Vice President, who has management and supervisory responsibilities over all of Shoreham's operations, regulated and non-regulated, are clearly subject to the joint-use property allocation between regulated and non-regulated operations, as are the garage facilities where such joint-use vehicles are housed or parked.

Shoreham's cost of service filing does not reflect an allocation to non-regulated

60. Abbott reb. pf. at 13-14; and exh. STC-7.
61. Abbott reb. pf. at 13.

operations depreciation expenses related to General Support Facilities, but such an allocation is required. 47 C.F.R. Part 64 (2004). Therefore, based on the above, I recommend that the Board should reduce General Support Facilities depreciation expense by $12,532, an adjustment that is derived by applying the Department's indirect allocator of 7.4% to GSF depreciation expenses.

(5) Re-allocation of a portion of Corporate Expense to Non-Regulated Activities

93. Corporate operations expense for Accounts 6710 and 6720 must be allocated between regulated and non-regulated operations. Smith pf. at 50.

94. It is appropriate to use a 7.4 percent allocation factor to determine the amount of Corporate Operations Expense that is associated with non-regulated activities. This is the same allocation factor that is used for the purpose of determining the amount of GSF plant that should be removed from rate base. Smith pf. at 29, 30, 49 and 50.

Discussion

An adjustment is needed to reflect an appropriate allocation of corporate operations expense to non-regulated operations. As was the prior adjustment for general support assets outlined above, this adjustment is necessary to comply with the requirements of 47 C.F.R. Part 64. The Department's adjustment appropriately uses the same indirect allocator of 7.4% that was used to separate jointly used GSF assets and associated expenses into regulated and non-regulated services. The Department applies the indirect allocator to Accounts 6710 and 6720 expenses that have not already been directly assigned to non-regulated services in order to separate the remaining costs between regulated and non-regulated services. This calculation reduces the Corporate Operations Expense by $29,943.

Shoreham asserts that the Department has inappropriately applied the indirect allocator because it believes that the Department has applied the factor to payroll and benefit expenses as well as other Corporate expenses such as electricity and computer expenses. Such a broad application of the indirect allocator would be inappropriate, according to Shoreham, because employees directly assign their time between non-regulated and regulated services.

The Department's proposed adjustment is reasonable and should be adopted for the reasons stated above. Exh. DPS-6, schedule C-10, removes from the Department's recommendation corporate payroll and benefits expenses. Thus, the Department has, appropriately, applied the allocation factor only to the expenses that cannot be directly separated between regulated and non-regulated services such as electricity, heat, computers and information technology management.

(6) Customer Deposit Interest

95. The Department proposes an adjustment of [CONFIDENTIAL] representing the amount of interest expense for customer deposits. Smith pf. at 55; exh. DPS-6, Schedule C-12.

96. Shoreham did not contest the Department's adjustment on rebuttal.

Discussion

Notwithstanding the positions of the parties and consistent with my findings and recommendation above relative to the inclusion of customer deposits in rate base, I recommend that the Board reject the Department's recommendation and find Shoreham's expenses related to interest on customer deposits to be an appropriate expense to be recovered in rates.

(7) Income Tax Expense

97. Shoreham is a Sub-chapter S Corporation for income tax purposes. As a consequence of this election, Shoreham does not pay federal or state income taxes. Behrns pf. at 6 and 10; tr. 5/27/04 at 22 and 44 (Gurley).

98. Net income distributed by Shoreham to the shareholders is combined with other personal income and deductions as reported by the shareholders to the taxing authorities and taxed at the shareholders individual federal and state tax rates. Behrns pf. at 6.

99. Vermont ILECs,[62] including Shoreham, calculate their revenue requirements for rate-making purposes at the effective corporate rate, which is approximately 40.4%.[63] Gurley reb. pf.

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62. All but two Vermont ILECs (Shoreham and Franklin Telephone Company, Inc.) are C Corporations and are taxed as a composite federal and state income tax rate that approximated 40.44% in 2002 and 2003.

63. The Vermont tax rate is 9.75% while the federal tax rate is approximately 34%. Thus, the effective tax rate of 40.4% is calculated in the following manner: (1-.0975) times 0.34, plus 0.0975.

at 5; Behrns pf. at 11; tr. 5/27/04 at 47 (Gurley); exh. STC-1, Schedule 4.

100. Shoreham calculated income taxes of $171,930 using the composite C-Corporation tax rate of 40.44% for ratemaking purposes, even though it is an S-Corporation. Exh. STC-1, Schedule 4.

101. Shoreham has been collecting from ratepayers monies for federal and state taxes as if it had been paying an effective corporate rate of approximately 40.4%. Tr. 5/27/04 at 22 (Gurley);

102. The individual stockholders of Shoreham, who are obligated to pay income taxes on income distributed by Shoreham, pay a different and lower rate than the C-Corporation rate. The personal income tax rate is 25.12%. Smith pf. at 52 and 55.

103. For the purpose of ratemaking, a proxy income tax expense of [CONFIDENTIAL] based on the estimated individual income tax rate of the shareholders is appropriate. Exh. DPS-5, Sch. C.2; Smith pf. at 55; Behrns pf. at 9.

Discussion

In its cost of service filing, Shoreham asserts that its proposed income tax expense is a legitimately incurred expense when, in fact, no taxes are paid. As an S Corporation, Shoreham is not obligated to pay federal and state income taxes. Instead, the obligation to pay income taxes is passed through to the stockholders. Each individual stockholder combines the income that is distributed by Shoreham with other income and tax deductions reported by the individual stockholder, and pays taxes on the resulting amount. Given that Shoreham does not pay income taxes, the Board could deny the inclusion of all income tax expenses reported in Shoreham's cost of service filing.

However, reducing income tax expenses to zero would be an unfair representation of the cost to provide service and would have the effect of denying shareholders the opportunity to earn

a fair return on invested capital. As a compromise between Shoreham's excessive proposed income tax expense and a zero allowance, the Department recommended an income tax expense adjustment based on the individual income tax rates of the shareholders. I find the Department's recommendation to be a fair compromise between the competing interests of ratepayers and

Shoreham's stockholders. Establishing an income tax expense of [CONFIDENTIAL], as calculated by the Department, provides an opportunity for Shoreham to generate additional revenues to pay for taxes on the income of the shareholders in the same manner that C Corporations are afforded the opportunity to generate revenues to pay their income taxes.

F. Cost of Capital

104. Shoreham's capital structure consists of 93% equity and 7% debt. Exh. STC-18.

105. The cost of equity represents the expected return that investors require, weighted by the proportion of equity to total capitalization. The expected equity return reflects the opportunity cost in other investments of comparable risk. Lesser pf. at 5; exh. STC-18; exh. DPS-21.

106. The cost of debt (4.56% pre-tax) represents a composite rate of interest charged by Shoreham's creditors, weighted by the proportion of debt to total capitalization. Exh. STC-18; exh. DPS-21.

107. Shoreham generally agrees with, and adopts, the methodology used by the Department for calculating a rate of return on equity ("ROE"). Gurley reb. pf. at 14.

108. Smaller companies are generally perceived to be riskier for investors because changes in the operational characteristics of the subject company create potentially large swings in financial conditions. Tr. 5/27/04 at 43 (Gurley).

109. Based on a hypothetical capital structure of 75% equity and 25% debt, the Weighted Average Cost of Capital ("WACC") is 9.35%, which includes an allowed rate of return on equity of 10.95%. Exh. DPS-21.

Discussion

The main dispute between the parties relative to the WACC centers on the appropriate capital structure and the proxy group of companies used to calculate the cost of equity.

(1) Capital Structure

In its analysis provided in Exhibit STC-17, Shoreham proposes a capital structure consisting of 8% debt and 92% equity.[64] The proposal is based primarily on a Telegree Benchmarking Study of similarly-sized companies' capital structures and a series of calculations. These calculations involve the ratio of the market value of equity and the market value of debt as of calendar year-end 2003.[65] Shoreham further asserts that its analysis represents the most appropriate capital structure for a company like Shoreham.[66]

I find Shoreham's argument to be unpersuasive. The Telegree study, which represents the starting point of Shoreham's analysis, includes a composite capital structure ratio of several companies as of the end of 2003. It does not, however, inform the Board of approved capital structures for the purpose of setting just and reasonable rates. Approved capital structures may or may not be considerably different than the capital structures that have been reported in the Telegree study. More importantly, Shoreham did not explain how its capital structure minimizes the overall cost of capital.

The Department asserts that Shoreham's capital structure includes an excessive amount of expensive equity, and recommends a hypothetical capital structure of 25% debt and 75% equity.[67] The goal of the utility should be, according to the Department, "to achieve a capital structure that minimizes its overall cost of capital."[68] I concur with the Department's position and find that a capital structure consisting of 25% debt and 75% equity will achieve the goal of minimizing capital costs.

I note that this recommendation, if accepted by the Board, would be a change in previous Board practice. Historically, the Board has typically used a 50\50 debt to equity capital structure to help guide its analysis of telephone company earnings. However, this practice may not be as reliable as it has been in the past. As wireless technology becomes more entrenched and newer technologies, such as Voice over Internet Protocol, begin to pose a threat to revenues, a hypothetical capital structure consisting of 50% debt may be considered excessive. A company with 50% debt would have less financial flexibility in the face of these potential risks than a

64. The fact that Shoreham's actual capital structure consists of 92.86% equity and 7.14% debt as of December 31, 2002 may or may not be coincidental.
65. Gurley pf. at 17-18; exh. STC-17.
66. Gurley pf. at 17-18; exh. STC-17.
67. Lesser pf. at 48.
68. Id. at 43.

company with a capital structure consisting of 25% debt. If investors determine that a company has too much leverage and is less flexible financially compared to other potential investments, then investors' required rate of return on equity would increase.[69] Based on this rationale, a decrease in the proportion of debt is necessary to minimize the overall risk-adjusted cost of capital. As a result, I am persuaded that a capital structure consisting of 25% debt and 75% equity is reasonable.

(2) Cost of Equity

In setting the Cost of Equity ("COE"), the Board attempts to determine a hypothetical investor's expectations of a fair rate of return on investments perceived to be of similar risk. Because investor expectations cannot be readily observed, it has been a long-standing practice to rely on statistical models, such as the Capital Asset Pricing Model ("CAPM"), the Risk Premium model ("RP"), and the Discounted Cash Flow ("DCF") model, to ascertain the best estimate of investors' expectations consistent with the principles set out in the U.S. Supreme Court's seminal *Hope*[70] and *Bluefield*[71] cases. Of these models, the DCF model is considered the most reliable indicator of investors' expectations. In order to use the three models, it is necessary to first select a group of companies with similar risks as the utility whose rates are being set. The specific companies selected can materially affect the results.

In this proceeding, Shoreham and the DPS disagree on the group of companies that should be used in the models. The DPS used six companies: ALLTEL, BellSouth, CenturyTel, SBC Communications, Sprint and TDS. Shoreham used the same six companies as the DPS plus Verizon and 13 other smaller companies in order to make the sample of companies "more representative" of the industry.[72] Six of the companies used only by Shoreham are not analyzed by Wall Street analysts.

The DPS's DCF model resulted in a range of expected returns from 7.01 percent to 14.63

69. Lesser pf. at 6.
70. *FPC v. Hope Natural Gas Company*, 320 U.S. 591 (1944)("*Hope*").
71. *Bluefield Water Works & Imp. Company v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) (*Bluefield)*.
72. Tr. 5/27/04 at 37 (Gurley); Gurley pf. reb. at 12; exh. STC-16.

percent,[73] while Shoreham's DCF model estimated a range of expected returns from 9.16 percent to 10.28 percent.[74] However, because the DCF model requires Wall Street analysts' forecasts of earnings per share and dividends per share growth, Shoreham could not calculate DCFs for the six companies that are not analyzed by Wall Street analysts.

Both the DPS and Shoreham averaged the results of their DCF analyses with the results of their respective CAPM and RP analyses to arrive at their respective COE recommendations. The DPS estimated the COE to range between 8.99 percent and 11.35 percent, with an average (of the averages) of 10.01 percent.[75] Shoreham estimated the COE to range between 9.16 percent and 15.78 percent, with an average of 13.03 percent.[76]

I am persuaded that Shoreham's analysis is flawed. As mentioned above, Shoreham could only calculate DCFs for 14 of the companies it had selected as comparable. In addition, Shoreham neglected to provide the CAPM results for two additional companies. Omitting the results of these eight companies unnecessarily skews the averaging process by giving more weight to Shoreham's RP result of 15.78 percent. Were Shoreham to omit from its analysis the eight companies and average the DCF, CAPM and RP end results of the remaining companies equally, the average of all methodologies would have been approximately 11.74 percent, not 13.03 percent.[77]

I am persuaded that the Department's COE analysis is reasonable and consistent with the principles set out in the *Hope* and *Bluefield* cases. However, I conclude that it is appropriate to allow Shoreham a higher COE than the 10.01 percent average calculated by the DPS because Shoreham is a small ILEC with operations in only one state. Smaller companies are generally perceived to be riskier by investors because changes in operational characteristics could result in large swings in the companies' financial conditions.[78] It is appropriate for Shoreham's shareholders to have the opportunity to earn a higher return on their investment in order to compensate them for this perceived higher risk. Based on the range of COE results in evidence

73. Lesser pf. at 42; exh. DPS-19.
74. Exh. STC-16. It should be noted that Shoreham's recommended CPE is 13.03 percent, which was derived by averaging the results of the DCF, CAPM, and RPS model runs.
75. Exh. DPS-19 (revised).
76. Exh. STC-16.
77. Exh. STC-16.
78. Gurley reb. pf. at 16-17; Lesser sur. pf. at 6-7.

in this proceeding, I conclude that an additional 0.94 percent return on equity is a reasonable premium for the perceived higher risk to Shoreham's shareholders. Therefore, I recommend that the Board establish a cost of equity of 10.95 percent for Shoreham.

V. Conclusion and Recommendations

Using the "total company" ratemaking methodology and with the cost of service adjustments, including rate base and cost of capital, that I recommend in the findings above, Shoreham is overearning by $1,126,725. Consequently, Shoreham's intrastate revenue requirement should be reduced to $941,450, with the Company's intrastate rates adjusted accordingly. This result is the outcome of applying all of my recommended adjustments to Exhibit DPS-RCS-1, including my recommended addition of a $100,000 incentive adjustment for Shoreham. The adjusted version of this exhibit is attached hereto as Appendix 1.

VI. Implementation of Rate Decrease

The DPS recommends that the Board address rate design issues related to the necessary rate decreases resulting from this case in a subsequent proceeding. Specifically, the Department suggests that because Shoreham's rate design has many elements, an optimal rate design should only be determined after the magnitude of the revenue reduction has been determined by this proceeding. While it is possible to reduce each of Shoreham's rate elements proportionally based on the total rate reduction to be ordered here, the Department contends that it is better, given the magnitude of the required revenue reductions, that the Board use this opportunity to better align Shoreham's service prices with its underlying costs in a way that would anticipate, rather than lag behind, industry trends and potential competitive pressures.[79]

Shoreham has maintained throughout this proceeding that there is no need for a subsequent rate design proceeding because Shoreham's current rates are just and reasonable and no rate reductions that would warrant a rate design proceeding are needed.

Given the magnitude of the excess earnings that have been identified based on the record evidence in this proceeding, I agree with the Department's proposal that a follow-on proceeding

79. Lackey pf. at 6-7.

be convened to explore re-designing Shoreham's intrastate rates. This review would be an opportunity to better align Shoreham's service prices with underlying costs and to implement a rate structure that anticipates industry trends and promotes the public good. I therefore recommend that the Board open a follow-on proceeding to resolve how to best implement the rate reduction that has been quantified and clearly justified as a result of the proceedings to date in this docket.

Based upon the substantial evidence of record and the testimony presented at the hearings, I hereby report the foregoing to the Board in accordance with 30 V.S.A. § 8. All findings proposed by the parties that are not incorporated herein are rejected. All of the proposals herein are subject to modification and final approval by the Board.

This Proposal for Decision has been served on all parties to this proceeding in accordance with 3 V.S.A. § 811.

DATED at Montpelier, Vermont, this 6th day of August, 2004.

s/Peter B. Meyer
Peter B. Meyer
Hearing Officer

VII. Board Discussion

Both Shoreham and the Department have requested that we modify the Hearing Officer's Proposal for Decision, in some cases significantly. We discuss each of the issues raised by the parties.

A. "Total Company" Ratemaking

The primary area of dispute is the appropriate methodology for setting Shoreham's intrastate rates. Like other incumbent local exchange carriers, Shoreham provides both interstate and intrastate services and its rate base and expenses are allocated between the two — intrastate cost recovery is based upon the share of costs that are not assigned to the interstate jurisdiction. Unlike other ILECs, however, Shoreham does not propose to use the same cost allocation method in both jurisdictions. Like most ILECs, Shoreham proposes to base intrastate rates upon historic and known and measurable costs. However, rather than basing its interstate costs upon the cost separations methodology that most companies use to allocate costs, Shoreham has elected to employ the "average schedule" approach, under which the FCC authorizes cost recovery based upon the average costs of a group of small local exchange carriers. This average schedule approach assigns more costs to the interstate jurisdiction than would occur if the FCC set the interstate rates based upon Shoreham's proposed cost allocations.

For intrastate cost recovery, Shoreham asks that we ignore the interstate cost allocation that is actually used for rate-setting, but instead base intrastate rates on its proposed allocations (which Shoreham asserts would apply to both jurisdictions if it had not elected average schedule-based interstate rates). The effect of this mixture of cost allocation methodologies would be that Shoreham's ratepayers would have to pay for some of the same plant and expenses twice — once through interstate rates and once through intrastate rates. Shoreham's owners would receive the benefit of this double collection, either directly in the form of dividends or through increased value of the Company. In this case, Shoreham asks that we continue to permit this practice. The Department requests that we employ a "total company" ratemaking methodology. Under this approach, we would accept the allocation of plant and expenses that actually are used to set interstate rates and then assign to the intrastate jurisdiction, the difference between the total costs and these interstate costs thereby avoiding double cost recovery.

In its comments on the Proposal for Decision, Shoreham requests that the Board reject the Hearing Officer's recommendation that we establish Shoreham's rates on a "total company" or "residual" ratemaking basis. Shoreham presents both legal and policy arguments in support of this position. Shoreham maintains that the Board is without statutory jurisdiction to use interstate revenues to subsidize the Company's intrastate rates. After careful consideration of the Company's arguments, we reject Shoreham's position and adopt the Hearing Officer's recommendation that the Company must determine its intrastate revenue requirement by employing the total company methodology.

(1) Board's Legal Authority

Shoreham first argues that the Board lacks statutory jurisdiction to abandon its long-standing acceptance of Shoreham's current separations methodology and adopt a "total company" ratemaking methodology. Shoreham cites the 1949 Vermont Supreme Court decision in *Petition of New England Telephone & Telegraph Co.*[80] and the 1977 decision in *In re New England Tel. & Tel. Co.*[81] and argues the Court narrowed the broad discretion over ratemaking methods that could be used by the then Public Service Commission. Shoreham asserts that the Proposal for Decision runs afoul of these Supreme Court rulings that limited the Board's jurisdiction; according to Shoreham, the only way for the Board to order a $1.268 million revenue reduction is to impermissibly use jurisdictionally interstate revenues to set intrastate rates.[82] This method, argues Shoreham, denies the Company the right to earn its allowed interstate return on equity.

80. *Petition of New England Telephone & Telegraph Co.*, 115 Vt. 494, 503 (1949).

81. *In re New England Tel. & Tel. Co.*, 135 Vt. at 532 (1973).

82. Shoreham's Exceptions to the Proposal for Decision, 8/3/04, p. 7. Significantly, in its comments on the Proposal for Decision, Shoreham does not argue that federal law preempts the Board from establishing rates on a "total company" basis, because that methodology impermissibly uses interstate revenues. As a result, we do not specifically rule on whether federal law preempts state adoption of total company ratemaking. However, as we explain below, the FCC (in a decision that was upheld by the federal court) has specifically ruled that state adoption of total company ratemaking is not preempted. *Mid-Plain Tel. Co.*, 5 F.C.C.R. 7050, 7050 (1990, *aff'd sub nom.*, *Crockett Tel Co. v. FCC*, 963 F.2d 1564 (D.C.Cir. 1992).

(a) Residual Ratemaking

We find Shoreham's jurisdictional argument to be unsupported by either the facts and the law. First, Shoreham's argument is based upon the premise that by using the residual ratemaking methodology, the Board is making use of interstate revenues to support intrastate rates. However, Shoreham's comments contain only assertions and are not supported by citations to the record demonstrating that interstate revenues have been used. Examination of the evidentiary record demonstrates that Shoreham is simply incorrect as a factual matter.

As explained in the Proposal for Decision, residual ratemaking does not use interstate revenues for intrastate purposes. Instead, it accepts the interstate/intrastate cost separation factors that are inherent in the "average schedule" interstate rates. The methodology then applies the FCC's allowed 11.25% return on equity to these interstate cost allocations, thus assuring that Shoreham has a fair opportunity to recover its interstate costs. It also uses an intrastate return rate that we establish for determining a return on intrastate investment, and then employs a weighted average of the interstate and intrastate returns in conjunction with the total regulated ratebase and expenses of Shoreham to produce a revenue requirement for the Company as a whole. Thereafter, the methodology simply derives the state share of revenues by subtracting interstate revenues (which are based upon the average schedule allocations plus the FCC-determined return) from the total. Under this approach, Shoreham has a reasonable opportunity to earn its authorized return on equity (or exceed it) in the interstate jurisdiction because the Board simply accepts the FCC's allocations and return on equity. Similarly, Shoreham can earn a fair return on its intrastate investment (as determined using the implied "average schedule" separations factors).

Upon closer examination, it is clear that Shoreham's argument that the Board is impermissibly using interstate revenues is predicated on its view that it is entitled to use one cost allocation methodology for interstate ratemaking purposes and another one for intrastate rates, even if the mix of two methodologies requires Vermont ratepayers to pay for the same property twice. Residual ratemaking can only be seen as using interstate revenues for state purposes if one compares those revenues to the interstate costs as derived from the cost allocation methodology that Shoreham sought to use for intrastate ratemaking purposes.[83] This is not, however, the method by which interstate rates actually are set. The average schedule methodology that the FCC offers, and that Shoreham has elected, assumes a much higher allocation of costs to the interstate jurisdiction. The total company ratemaking approach accepts this fact and uses it as the basis for cost allocations.

As the Hearing Officer pointed out, court decisions have supported the conclusion that total company ratemaking does not impermissibly use interstate revenues or otherwise contravene federal law. As the United States Supreme Court has observed, the Act:

> grants to the FCC the authority to regulate "interstate and foreign commerce in wire and radio communication," 47 U.S.C. § 151, while expressly denying that agency "jurisdiction with respect to . . . intrastate communication service" . . . . However, while the Act would seem to divide the world of domestic telephone service neatly into two hemispheres . . . in practice, the realities of technology and economics belie such a clean parceling of responsibility. This is so because virtually all telephone plant that is used to provide intrastate service is also used to provide interstate service, and is thus conceivably within the jurisdiction of both state and federal authorities.[84]

To ensure that the FCC and each state acts within their own area of jurisdiction, it is necessary to apportion a utility's revenues, investment and expenses between the two jurisdictions.[85]

Applying these principles to the total company approach, the FCC has found that total company ratemaking is consistent with the jurisdictional division embedded in the Act. In reviewing a decision from the Wisconsin Public Service Commission ("WPSC") using residual ratemaking, the FCC summarized its ruling as follows:

> we conclude that this Commission has not prescribed any jurisdictional separations method for average schedule companies, and the WPSC's use of residual ratemaking for determining Mid-Plains' intrastate revenue requirement does not contravene the Communications Act or any rule of this Commission. Mid-Plains has not presented a preemption question because the WPSC has not taken any action that conflicts with any

83. Shoreham acknowledged as much during oral argument, noting that at the present time, Shoreham derives an "over-recovery relative to the actual interstate costs, but the actual interstate costs are never actually quantified by the Company." Tr. 8/6/04 at 20.

84. *Louisiana Public Service Commission v. FCC*, 476 U.S.355, 360 (1986).

85. *Mid-Plain Tel. Co.*, 5 F.C.C.R. 7050, 7050 (1990, *aff'd sub nom.*, *Crockett Tel. Co. v. FCC*, 963 F.2d 1564 (D.C.Cir. 1992).

> federal law, rule or policy.[86]

This finding makes clear that residual ratemaking does not impermissibly intrude on matters within the purview of the FCC, including interstate revenues. On appeal, the Court of Appeals for the District of Columbia Circuit upheld the FCC's determination.[87] The Court observed that:

> Insofar as the cost basis underlies average schedule ratemaking, there is no inconsistency in allowing the states to base their rates on the same relatively inexpensive method of computing the facility component of ratebase that the federal regulator uses.[88]

The Court also concluded that it was not unreasonable for states to "view the average schedule computation as an informal jurisdictional separation" that complied with the jurisdictional restraints on the states.[89]

Thus, even if we accept the proposition put forward by Shoreham that the Vermont Supreme Court's 1949 *New England Telephone* case limits our jurisdiction, Shoreham has not shown that the facts support the conclusions it espouses.

(b) The *New England Telephone* Cases

Shoreham also argues that the Vermont Supreme Court's decisions in the two *New England Telephone* cases limits this Board's authority to use residual ratemaking. We are unpersuaded and agree with the Department and the Hearing Officer that the first of these cases cannot be so broadly construed and that the second one actually upholds the Board's authority to proscribe a separations methodology, such as the residual ratemaking approach we adopt here. In the 1949 case, the Supreme Court ruled that the Board could not base rates upon the interstate portion of a ratebase. The Court's ruling does not address interstate revenues. Specifically, it does not proscribe a ratemaking methodology such as total company that takes a telephone company's combined interstate and intrastate revenue stream, accepts the interstate allocations embedded in the average schedules, and establishes intrastate rates based upon the residual costs.

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86. *Id*.
87. *Crockett Tel. Co. v. F.C.C.,* 963 F. 2d 1564, 1567, (D.C. Cir. 1992).
88. *Id*. at 1572.
89. *Id*. at 1573. Precedent in other states leads to the same conclusion. See *Petition of Mid-Plains Telephone, Inc.,* Docket No. 3650-DR-100, Final Order (Wisconsin Public Serv. Comm'n, Mar. 14, 1989); *Pine Tree Telephone & Telegraph Co.* v. Public Utilities Commission, 631 A.2d 57, 65–66 (1993).

The 1949 *New England Telephone* case discusses only the impropriety of aggregating interstate and intrastate investment property in ratebase for intrastate ratemaking purposes. As the United States Supreme Court's *Louisiana* decision makes clear, jurisdictional limitations in one area do not necessarily limit the authority in other areas.[90]

Shoreham also cites to the Vermont Supreme Court's 1977 decision in *New England Telephone and Telegraph Company*, 135 Vt. 527 (1977) to support its contention that Vermont law limits the Board's authority. That decision, however, explicitly acknowledges the Board's authority to establish a methodology for separations. The Court, while recognizing that the FCC has jurisdiction over interstate operations, upheld the Board's allocation of costs to intrastate operations, holding that "*the FCC has not pre-empted the issue of separations*, since no irreconcilable difficulties have been created between regulation by the federal agency and a state agency, the Board."[91] Total company ratemaking is simply a form of cost separations that begins with the interstate cost allocations embedded in the average schedules. Thus, it is within the Board's authority under the Court's reasoning.

(2) "Results-Oriented" Ratemaking

Shoreham attacks the Hearing Officer's motives, arguing that he relied unduly on a "results-oriented" analysis. Shoreham implies that the Hearing Officer recommended total-company ratemaking only because, in this specific case, that methodology leads to lower intrastate rates. Shoreham argues that the total company methodology is equally likely to either under-recover or over-recover interstate settlements relative to actual interstate costs. Shoreham also says that an intrastate surplus could be improperly used to subsidize an interstate shortfall. According to Shoreham, the Board should not adopt a ratemaking methodology just because in the near term the resulting subsidies would appear to benefit intrastate ratepayers.

Shoreham has not persuaded us that the adoption of total company ratemaking is inappropriately "results-oriented" and might lead to subsidies between interstate and intrastate

90. Thus, broad federal authority to set depreciation rates did not prevent the Louisiana Public Service Commission from setting its own depreciation rates for intrastate ratemaking purposes.

91. 135 Vt. at 532 (emphasis added). Considering the FCC's *Mid-Plains* decision, it is clear that no conflict exists.

ratepayers. Under Vermont law, our task is to establish rates that are just and reasonable. The Vermont Supreme Court has made clear that our selection of ratemaking methodologies is broad, so long as it directed to achieving this goal. Where the evidence shows that the outcome of a particular methodology is not just and reasonable, it is appropriate to select one that meets the statutory standard and is in the best interest of the state. Thus, for example, the Board permitted Green Mountain Power Corporation to recover costs that were neither prudent nor used and useful, because the end result was just and reasonable.[92] That standard is fully consistent with the United States Supreme Court's rulings that "under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling . . . it is not theory but the impact of the rate order which counts."[93]

Because our ultimate goal is to ensure that the intrastate rates we authorize are just and reasonable (as required by Section 218(a) of Title 30), our choice of ratemaking methodology depends upon the facts before us. In this case, the evidence shows that Shoreham has elected to use the "average schedule" methodology for determining its interstate revenue requirement as a substitute for the more common "cost" methodology under which each plant and expense cost category is separated individually according to the FCC's separations rules.[94] The effect of Shoreham's choice is that the costs allocated to intrastate rates (using Shoreham's cost allocations) plus the costs allocated to interstate rates (using the average schedule methodology) would exceed Shoreham's total costs. Faced with these facts, we find that adoption of residual ratemaking is appropriate and will ensure that rates are just and reasonable. This avoids requiring Shoreham's ratepayers to pay intrastate rates for the same plant and operations that Shoreham has already been compensated for through interstate rates. Thus, we accept the Hearing Officer's recommendation to set rates based upon total company ratemaking, a sound methodology that is consistent with both federal law and precedent in at least two other states.

If, however, Shoreham were to remain an average schedule company, it might conceivably have lower interstate revenues than that it would have as a "cost company" that is

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92. Docket 6107, Order of 1/23/01.

93. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). *See* also *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1988).

94. *See* 47 C.F.R. Part 36.

subject to the usual FCC separations rules. An important fact in such a hypothetical case would be Shoreham's reasons for remaining in the average schedule category despite the adverse financial consequences. The decision might be a reasonable one, and in such a case we would be likely to continue applying the residual ratemaking approach. On the other hand, the decision to remain an average schedule company might not be reasonable, and in order to approve just and reasonable intrastate rates we might set rates using the methodologies we have used in the past. In neither case would such decisions be "results-oriented" other than, as the statute requires, seeking results that are just and reasonable under all the circumstances.

(3) Incentives

In comments during oral argument, the DPS expressed support for the concept of providing Shoreham incentives to remain an average schedule company. Since the incentive payment does not appear to be tied to any cost projected by the Company in its cost of service, the Department suggests that it would be more in keeping with ratemaking precedent to adjust the proposed return on equity in an amount that will generate the $100,000 incentive. Also, the DPS suggests that the Board's final order in this docket should plainly state that this incentive is uniquely tailored to the facts of this case and is not intended to be construed as a precedent in future rate proceedings. Finally, the Department maintained that the Proposal for Decision should be amended to clarify that Shoreham will only be able to recover this incentive amount as long as its costs remain below the applicable average schedule settlement that it is permitted to recover as an average schedule company.

We have considered both the Hearing Officer's recommendation and the Department's comments and conclude that we should neither include a specific cost incentive nor adjust Shoreham's return on equity. The Hearing Officer's recommended inclusion of an additional $100,000 in intrastate rates was based upon an approximation of the Company's additional cost if it were to become a cost company for interstate cost recovery purposes (see Finding No. 19 above). Thus, the Hearing Officer concluded that by providing this potential cost in rates, Shoreham would have an added incentive to remain an average schedule company for interstate ratemaking purposes. We disagree with the Hearing Officer's proposal for two reasons.

First, Shoreham will not incur the $100,000 cost item. Under ratemaking principles that we have consistently applied, we set Shoreham's rates based upon actual costs adjusted for known and measurable changes. The $100,000 fits into neither of these categories. At this time, it is entirely speculative that Shoreham will actually incur the additional costs associated with separating interstate and intrastate costs based upon the FCC's cost allocation approaches. These costs estimates are not, therefore, known and measurable and not recoverable in rates.

Second, Shoreham already has ample incentive to ensure that ratepayers do not pay unnecessary costs, such as those associated with moving to a cost basis approach for its accounting. In considering whether to continue to operate as an average schedule company or to switch to becoming a cost company, Shoreham will need to evaluate the interests of shareholders and, also, of its customers. At the present time, there appears to be little difference between the two approaches from the shareholders' perspective, particularly since we have incorporated the higher, federal return on equity into our calculations of a reasonable total-company cost of service. Shoreham, however, would likely experience higher costs if it elected to become a cost company. This would result primarily from the approximately $100,000 in added costs that Shoreham would have to incur to conduct cost studies and allocate costs (these are the costs that the Hearing Officer based his recommendation upon). Although Shoreham may seek to pass these costs on to ratepayers, Shoreham already has an incentive to avoid the additional $100,000 that would result. Moreover, since Shoreham's ratepayers would derive no benefit from these added costs, there appears to be no valid reason for Shoreham to abandon its current election to set interstate rates based upon average schedules. Based upon the record before us, we see no reason that we need to provide incentives for Shoreham not to take a step whose primary effect would be to harm ratepayers.[95]

(4) Impact of Recommended Change in Methodology

Shoreham maintains that the Hearing Officer failed to take into account the impact on Shoreham's operations if it were to abandon the average schedule for interstate settlement purposes and elect to be a cost company. Full consideration of the costs and benefits of total

95. As we discuss below, for this reason, it may be imprudent for Shoreham to abandon the present, average schedule interstate ratemaking approach.

company ratemaking, Shoreham argues, militate against adoption of total company ratemaking. Shoreham suggests that its feasibility study (which is in the evidentiary record) shows that the Company's intrastate revenue requirement (and therefore intrastate rates) would be roughly equivalent to the intrastate revenue requirement that Shoreham supported with its original cost of service study in this proceeding. Shoreham also suggests that if rates are lowered because of this proceeding and then the Company elects to become a cost company, rates would have to be increased, causing rate shock for customers.

We are unpersuaded. In light of all the evidence in the record, the Hearing Officer's decision not to give more weight to the feasibility study was reasonable. We do not see how the possibility that rates may have to be raised, if the Company should elect to become a cost company, should have any significant bearing on our decision to approve total company ratemaking when the Company is not now a cost company *and* the evidence shows that rates are not now just and reasonable. There is no evidence that the Company will actually make this election, and any prognostication about a future decision by the Company to become a cost company is merely speculation. There are many factors that will inform the Company's decision as to whether it remains an average schedule company going forward. One very important consideration should be the effect that such a decision will have on its customers. As the Company currently operates, total company ratemaking will significantly benefit Vermont customers. We presume that Shoreham will only make a decision in this regard that would significantly change its revenue streams, both interstate and intrastate, if it is convinced that such a decision is in the best interests of the Company *and* its ratepayers.

We note, however, that Shoreham's comments suggest that, if the Board adopts a total company ratemaking methodology, Shoreham will elect to discontinue setting interstate rates on an average schedule basis.[96] As the federal rules now stand, it is clear that such an election would be harmful to ratepayers and would also seem to be counterproductive in its effect on the Company. The record demonstrates that continuation of average schedule ratemaking for interstate rates with total company ratemaking for intrastate rates will be less costly for ratepayers than operation as exclusively a cost company (particularly considering the fact that it could

96. Shoreham reiterated this suggestion in a filing after the oral argument.

increase Shoreham's costs by an extra $100,000). If Shoreham were to abandon average schedule ratemaking (a choice that may be within Shoreham's discretion), we would expect that such a choice would be made *only* after assuring that ratepayers as a whole would see no increase in rates. Otherwise, we would be likely to impute into Shoreham's intrastate rates the savings from Shoreham's selection of an interstate ratemaking methodology that resulted in the lowest total costs to Vermont ratepayers (which the evidence now shows to be total company ratemaking). That would be similar to the "imputed" treatment of Yellow Pages revenue in several cost-of-service cases involving Bell Operating Companies after the break-up of AT&T in the 1980's.

Shoreham also argues that adoption of total company ratemaking as recommend by the Hearing Officer will fundamentally alter the day-to-day operations of the Company. The required revenue reductions of about one third will damage company operations, Shoreham suggests, because it has made all of its operational decisions, including hiring, payroll, capital investment, office and outside plant construction, contracts with service providers, and the deployment of innovative and advanced telecommunications services, in reliance on the ratemaking methodology that the Board and the Department have accepted for several decades. Shoreham states that "(i)t strains credulity to suggest that those decisions can now be unmade or re-cast in a matter of weeks without imposing severe stresses on the Company's operations."[97]

Actually, Shoreham has had formal notice since the opening of this docket nine months ago, not the "matter of weeks that it now asserts." Moreover, a reduction in return on equity would only reduce earnings, *not* impede its ability to recover operating costs. However, we are mindful of the significant effect that our decision to make the change to total company ratemaking will have on Shoreham's net, total company revenues in the near term. Shoreham will have ample revenue to cover costs and earn a fair return, but may need some time to adapt to the revenues that result from total company ratemaking and, perhaps, adjust its operations. Consequently, even though we conclude that Shoreham's 2004 intrastate rates are about $1,268,000 above just and reasonable levels, we will not implement any rate reductions immediately (or order a retroactive refund to the beginning of the rate year). Instead, we will order the rate reductions to be implemented in three equal phases. Shoreham shall implement the

97. Shoreham's Exceptions to the Proposal for Decision, 8/3/04, at 2.

first revenue reduction by January 1, 2005, the second revenue reduction by August 1, 2005, and shall achieve the final one-third reduction by August 1, 2006. We recognize that this allows Shoreham to continue to earn at levels well above just and reasonable amounts until the completion of the phase-in on August 1, 2006. However, we find this transition period to be reasonable considering the quantity of the rate reductions.

During the rate investigation, parties did not present recommendations on the specific rate elements that Shoreham should modify. In order to permit the first stage of the rate reductions to occur by January 1, 2005, we direct Shoreham to file proposed rate reductions (for all three phases) within 15 days of this Order. The Department shall submit any comments within 10 calendar days after receipt of Shoreham's proposal.

(5) Role of Docket 6401

In its comments on the Proposal for Decision, Shoreham states that it is troubled by the Hearing Officer's "terse dismissal"[98] of the weight and presumption of correctness that should be given to the Board's most recent approval order of Shoreham's rates in Docket No. 6401. The Company suggests that by stating that the Board did not rule on the appropriateness of the ratemaking methodology used in that case because it was a bottom line settlement, the Final Order approving those rates in that case is accorded less presumption of correctness than it should be given. Shoreham argues that this implies that even where there is undisputed acceptance of a ratemaking methodology in a prior case, the Board may disregard or discount its own approval orders if there was a bottom line settlement on issues that were in dispute.

We cannot agree with the Company's assessment of the relevance of Docket No. 6401. In that case, because there was a stipulated bottom-line settlement in that docket, the Board did not *specifically* rule on either the appropriateness of the ratemaking methodology employed or the cost and revenues in the cost of service that supported those rates. When parties request that the Board accept a bottom-line settlement, they seek only a finding that the resulting rates are just and reasonable. The parties themselves do not necessarily agree on the specific costs, revenues, or even methodologies that produce the rates, but only that the result is fair. The Board's

98. Shoreham's Exceptions to the Proposal for Decision, 8/3/04, at 9.

approval of such a settlement goes no farther than the evidence permits — in the case of a bottom-line settlement, the Board can only reach affirmative conclusions on the final rates, not the components thereof or even the methodology.[99] Indeed, it seems counterproductive for Shoreham's counsel to present a stipulation in 2001 that disavowed review of any specific methodology or rate element and, now, in 2004 to argue that other parties must defer to those elements. In light of the limited scope of the review requested by Shoreham in Docket 6401, the Hearing Officer afforded appropriate weight to the Board's approval of that settlement.

Moreover, Shoreham also overstates the presumptions that apply in rate cases. As we have consistently held, the Company's existing costs, as reflected in the cost of service are afforded a presumption of reasonableness. However, that presumption is rebuttable. Once the Department or another party presents sufficient evidence to rebut the presumption, the burden of proof rests with Shoreham on each rebutted item of its cost of service. In this case, the Department presented ample evidence to rebut Shoreham's asserted costs (and ratemaking methodology) and shift the burden back to the Company. Following a precedent that has been established over many years in prior Board proceedings is critical to a fair and effective regulatory environment. However, there are times when the facts and circumstances of a case mandate a change in methodology to ensure protection for ratepayers. This is such a case.

(6) Timing

Finally, in comments filed after the oral argument, Shoreham suggests that it was inappropriate to litigate both the ratemaking methodology and the rates themselves within the seven-months prescribed by Section 226(b). According to Shoreham, it is inappropriate to consider policy in a rate case. Shoreham points to the fact that the Board has now decided to defer issuing this Order until after the seven-month period has expired as evidence that combining the issues was incorrect.

We find Shoreham's new assertions to be contrary to legislative intent and puzzling as

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99. This decision does not reflect a change in our long-standing policies that favor negotiated settlements over litigated outcomes. We continue to support such outcomes when settlements are based on the record evidence and support ratepayer interests. Rather, our ruling reflects the limited findings involved in our acceptance of a bottom-line settlement. Parties could, of course, reach agreement as to the specific components of a settlement. Shoreham and the Department did not do so in Docket 6401.

well. Our postponement of a final order was done for the purpose of easing the impact on management and owners.[100] Our rate decisions routinely require us to make policy choices and, under Section 227, we must make these decisions within a seven-month period. This proceeding was no different. As the Department's evidence showed, it was quite possible to present evidence on both the appropriate ratemaking methodology and the rates under each approach within the statutory time frame. The record shows that Shoreham's difficulties with the mix of policy and rates in this case stems less from the seven-month deadline than from the tactical choices Shoreham and its counsel made in litigating this case.

Contrary to Shoreham's assertions, our decision to allow the seven-month period to expire and to phase in the rates was not based upon the difficulty of rendering a timely decision. We could have issued a ruling within the seven-month period under Section 227(b) (as extended by Shoreham). Under Vermont law, this would have required that the rates be retroactive to January 1, 2004, which would have had a significant affect on the Company. Faced with this alternative, we concluded that it was appropriate to allow the statutory period to expire and to instead phase in the rate reductions we now require based upon adoption of a total company methodology and not to have them occur retroactively. This decision was made specifically to assist Shoreham's management in adapting to the lower intrastate rates.

B. Cost of Service Adjustments

(1) Accumulated Depreciation

In its comments on the Proposal for Decision, Shoreham asserts that the Hearing Officer's proposal to increase accumulated depreciation by $1,033,930 (as the Department has recommended) does not account for additional plant investments that have occurred or will occur during the adjusted test year (2004) and would undermine Shoreham's ability to render service. Shoreham argues that the Board should not adjust rate base to reflect accumulated depreciation without recognizing known and measurable effects from additional plant investment. Shoreham

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100. The effect is to allow Shoreham's owners to collect $541,655 for 2004 and $704,037 for 2005 in excess earnings. Since this amount is nearly twice Shoreham's necessary annual intrastate revenue requirement of $799,716, the deferral should buffer the transition, a result that one would expect Shoreham to welcome, rather than use as a basis for complaint.

maintains that the record evidence supports the inclusion of approximately $112,000 in plant investments made in 2003. Shoreham also states that it has already spent $108,500 in plant investments since the beginning of 2004 and has contracted for or budgeted an additional $920,475 in plant additions through the end of the year.[101]

The record demonstrates that known and measurable increases in accumulated depreciation occurred (and will occur) during the test-year and rate-year. Consistent with the Vermont Supreme Court's directive in *Green Mountain*, the Board must recognize these adjustments to rate base. Thus, we concur with the Hearing Officer's recommendation to reflect additional accumulated depreciation as an adjustment to rate base. In the face of undisputed evidence demonstrating these known and measurable changes, the Board cannot grant Shoreham's request to freeze the value of its rate base as of the end of the 2002 test-year for the purpose of setting rates and still remain consistent with the Court's mandate.

Following the Supreme Court precedent does not, however, result in an artificially low rate base, as Shoreham suggests. In addition to reflecting accumulated depreciation subsequent to the test year, the Board also recognizes plant additions in the adjusted test year and interim period if the Company can demonstrate that those additions meet the known and measurable standard. Shoreham's rate base is a reflection of the fact that Shoreham cannot demonstrate such plant additions. Specifically, the record does not support Shoreham's contention that it made $112,000 in known and measurable plant additions during 2003. None of Shoreham's filings or testimony discusses these plant additions. The only reference to such additions any place in the record is Board Exhibit-1 (the Company's 2003 Annual Report) which shows approximately $112,000 of construction for 2003, but neither explains what the plant additions are, nor how (or even whether) they are related to regulated activities. There are two problems here: first, this kind of post-record presentation of a claim is very unfair to other litigants (i.e., the Department on behalf of ratepayers); and, second, even after-the-fact, there is no information showing that the $112,000 is for activities that Shoreham may recover in rates. Thus, we decline to modify the

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101. The rate base additions for 2004 cited by Shoreham are not in the evidentiary record. Shoreham had multiple opportunities to present such evidence but elected not to during the more than seven months that this investigation took place. Only in its comments on the Proposal for Decision (well after the close of the evidentiary record) did Shoreham produce its projections of future rate base additions.

Proposal for Decision regarding 2003 investments in the rate base.

Additionally, Shoreham has not presented any evidence in the record to support its asserted 2004 rate base additions. The rate base additions cited in its comments are not based upon information in the record, but rather projections that could have, and should have, been presented earlier. Moreover, Shoreham itself does not take the position that its projected plant additions are known and measurable, but instead characterizes them as "budgeted." We also note that the investment that Shoreham now proposes to make during the remaining one-quarter of the year is approximately three times its average annual investment levels over the preceding three years. Thus, particularly as the Department has not had an opportunity to conduct discovery, cross-examine, and present its own evidence concerning the basis for the proposed plant additions, we cannot find that Shoreham's new projections are known and measurable.[102]

Shoreham also expressed concern that it will not be able to provide quality service to customers unless it is able to recover the cost of the 2003 and 2004 plant additions. Shoreham's concern is misplaced; we find no evidence in the record to support the conclusion that Shoreham's customers will be harmed unless we increase rates to include expenses that are not substantiated in the record and are neither known nor measurable. Nonetheless, we recognize that certain aspects of Shoreham's situation are unique. Shoreham has had a history of providing high quality service to its customers. In 2003, Shoreham entered into a sales agreement that limited management's discretion to make additional plant investments during both 2003 and 2004. This sales agreement (which, based upon evidence in the record, remains in effect) has directly led to the lower investment levels that are reflected in the cost of service we find

102. In a supplemental filing subsequent to the oral argument, Shoreham states that the record shows plant additions for 2004 totaling $443,000. The record does not support Shoreham's new assertions. The document cited by Shoreham to support its claim — Shoreham's Feasibility Study — was a comparison between rates assuming that Shoreham began operating as a cost company and the rates that Shoreham assumed based upon residual ratemaking. Nowhere in Exhibit STC-9, which Shoreham cited, does Shoreham present any evidence of specific rate base additions and a showing that they are known and measurable. In fact, the exhibit does not identify any rate base additions at all, but was represented by Shoreham's witnesses to be simply a comparison between rates under two different rate-setting methodologies. Moreover, Shoreham does not even identify where on Exhibit STC-9 the purported rate base additions exist. Shoreham's new reliance upon this document is simply unpersuasive.

reasonable.[103] We do not expect that the limitations on investment will continue indefinitely, however. Instead, it is reasonable to expect that over the period of time in which we phase in the rate reductions, Shoreham is likely to return to investment levels more typical of the average of the last three years.

A second unusual aspect of Shoreham's current situation is the fact that we have concluded that the rate reductions necessary to establish just and reasonable rates should not take effect immediately, but rather should be implemented over the next year and a half. This means that, although we are establishing rates based upon the adjusted test year of 2004, the rates we set will not be fully implemented until 2006.

This Board has considerable discretion in the methods in which we establish rates, so long as the results are just and reasonable. This duty has led us, when warranted, to depart from a firm adherence to the "test year adjusted for known and measurable changes" methodology that we typically employ.[104] In this case, the unique investment situation in which Shoreham now finds itself and the fact that we expect that over the period in which the lower rates will be implemented Shoreham's investment will be higher, justifies a minor departure from that methodology. For these reasons, we find it reasonable to include in Shoreham's ratebase additional investments more reflective of Shoreham's normal investment patterns. Accordingly, we will adjust Shoreham's rate base to permit the addition of $336,963 to rate base. This figure represents the average annual investment over the period 2001–2003, adjusted to remove unregulated investment, and is more in keeping with the investment levels that we expect will occur during 2005 and 2006.

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103. Shoreham's management voluntarily made its own choice to enter into this type of an agreement, presumably in return for greater value to Shoreham's owners as part of the overall bargaining for sale. However, their decision to restrict investment does not require us to set rates based upon "phantom" investment levels that simply have not occurred. Shoreham's internal sales-bargaining decision simply cannot relieve the Company from the obligation to continue to provide quality services or to prove that such investments are used and useful. Additionally, the weight of evidence clearly indicates that Shoreham does not intend to allow investment levels to drop to levels that would inhibit the Company's ability to continue to render quality services. Tr. 5/25/04 at 56-7 (Abbott).

104. *See* Docket 6107, Order of 1/23/01 at 65–73.

(2) Cash Working Capital

The Proposal for Decision recommends including $233,235 in rate base for Cash Working Capital. The Department maintains that the conclusions reached by the Hearing Officer are not supported by the record evidence. Shoreham's evidence, according to the Department, does not support the 45-day lag period recommended by the Hearing Officer and only creates an inference that a lag exists between the time that it receives payment for 62% of its total revenues and the time that it makes payments to sustain its operations. Further, the DPS suggests that the Hearing Officer's rationale for the use of the 45-day lag period is flawed because it relies on the lag period set out in the Department's annual report screening process, a purpose for which it was never intended. Because annual reporting and ratemaking are two fundamentally different pursuits, the DPS argues that the factor used to impute to Shoreham a Cash Working Capital allowance should not fluctuate depending on whatever factor the DPS may choose to use in future annual reporting requirements. Finally, the Department suggests, without conceding the propriety of such an imputation, that if a Cash Working Capital allowance is to be imputed without a lead-lag study, that it is more reasonable to use a 15-day standard that is consistent with NECA's standard allowance method as reflected in the record.

We agree with the Department that the Hearing Officer's recommended 45-day Cash Working Capital allowance is not supported by the record. However, because Shoreham does experience some lag in its receipt of payment for its services, the Department's original proposal for a $0 Cash Working Capital allowance absent a lead-lag study also is not reasonable. Requiring Shoreham to conduct an expensive lead-lag study would unjustly require Shoreham's ratepayers to pay for a study that would produce marginal, if any, benefits. The cost of the study could easily exceed the amount of the reduction in revenues associated with a lower Cash Working Capital requirement.

We will allow a Cash Working Capital of $80,077 based on a 15-day lag period. That period is probably imprecise, but the record evidence suggests that it is probably close to accurate. The evidence shows that the Company bills for approximately 38% of its revenues from customers in advance of providing basic service, payments for other services are due from customers within 30 days after the services are provided, the Company pays most of its bills within 15 days of receipt, and it pays its employees weekly. Tr. 5/25/04 at 216. These facts suggest that, although there is a lag between the Company's receipt of payment for its services and its obligations to pay its employees and other services, the lag is not substantial. Consequently, a 15-day lag period, as suggested by the DPS as an alternative to its recommended zero allowance, is appropriate. The reasonableness of this lag period is reinforced by the 15-day lag period used by NECA for Cash Working Capital for average schedule companies.

Finally, we reject the Hearing Officer's suggestion that we should rely on a 45-day lag period because the DPS uses this period for its annual report screening process. We agree with the Department that annual reporting and ratemaking are fundamentally different and an element used in an annual report screening process should not be used for ratemaking, particularly when it may fluctuate depending on whatever factor the DPS may choose to use in future annual reporting requirements.

(3) Income Tax Expense

As a Subchapter S Corporation, Shoreham does not pay state or federal income taxes. The obligation to pay income taxes is instead passed through to the shareholders of the Company. Even though Shoreham does not incur income taxes directly, current rates include the recovery of income taxes as if Shoreham was paying a composite rate of 40.44%, the rate that applies to Subchapter C Corporations. Rather than reduce the income tax expense to zero, which is the amount of income taxes that Shoreham actually pays, the Hearing Officer recommends an income tax expense based on the 2003 composite personal income tax rates of the shareholders, which was 25.12%.

In its comments on the Proposal for Decision, Shoreham maintains that establishing rates based on the personal income tax rate of the individual shareholders is subject to fluctuations and, therefore, potentially confiscatory in the event that future personal tax expenses differ from the amount of taxes included in the Proposal for Decision.

In an investigation such as this one, our task is to establish just and reasonable rates. As we have explained elsewhere, we routinely employ a methodology that starts with test year expenses and then adjusts those expenses to reflect known and measurable changes between the test year and the period the rates will be in effect (the adjusted test year — here, 2004). We recognize that not all costs in the adjusted test year will precisely match the values we derive from the use of this ratemaking methodology; short of establishing rates retroactively, no methodology could produce such a result. However, this ratemaking approach, which allows the Company to submit evidence to show that certain cost changes are highly probable (and thus known and measurable) fairly balances the competing interests of Shoreham's ratepayers and shareholders.

In the case of the personal income taxes, the evidence demonstrates that, even though Shoreham included a line item for income taxes in its 2002 cost of service, Shoreham, as a company, pays neither state nor federal income taxes. Simply put, payment of taxes simply was not one of Shoreham's *actual* expenses in the 2002 test year. Because of this, it is not appropriate to include income tax expense in the adjusted test year as a known and measurable expense; as long as it remains a Subchapter S corporation, Shoreham will not pay any income taxes in 2004 or in the future. Accordingly, we find that the income tax expense should be excluded from the cost of service.

We recognize that Shoreham's owners as individuals, and like many other investors, will pay income tax on earnings and distributions from the Company. Under federal and state tax law, these sources of income are taxed at the owners' personal income tax rate. This is a direct corollary of Shoreham's internal decision to choose a Subchapter S corporate form and enjoy its attendant benefits. These tax obligations are not, however, expenses that Shoreham (as an incorporated entity) itself must pay. In essence they are an additional form of compensation to investors (who also happen to be employees). In some future case Shoreham might (or might not) be able to justify such payments as a form of employee compensation, or as a necessary payment for capital. However, in this case Shoreham claimed compensation for these costs as income taxes, which they are not. Thus, they cannot be included among the Company's recognized costs of service.

(4) Accumulated Deferred Income Taxes

Both parties agree that, if we reduce the income tax expense, we must also reduce

Accumulated Deferred Income Taxes ("ADIT") to reflect changes in income tax rates.[105] The parties disagree, however, on how the reduction should be accomplished and what to do with the excess funds that Shoreham has generated by applying the Subchapter C rate. Shoreham proposed that it would recalculate the ADIT immediately, based on the future taxes due using the owners' personal income tax rate, and then keep the difference between the amount already collected from ratepayers and the amount actually due. In contrast to Shoreham's proposal, the Department proposed to amortize the excess funds over time and reimburse ratepayers who had already provided the funds to the Company with the expectation that the Company would incur future income tax expenses at the higher, corporate rate. The Hearing Officer adopted the Department's recommendation.

We accept the parties' representations that, for accounting purposes, Shoreham must recalculate the ADIT liability. In fact, based upon our ruling on the appropriate income tax rate for Shoreham, we would expect that the future obligation is likely to be zero — as we found, Shoreham pays no state or federal income taxes and thus has no future deferred income tax liability.

The more significant question before us is the status of the existing ADIT account. Even though Shoreham's future income tax expenses are reduced for the purpose of setting rates so that some or all of these funds are no longer needed, we find no basis to conclude that Shoreham and its owners are now entitled to keep the money credited to the ADIT account. ADIT is money that this Board has authorized Shoreham to collect in advance from ratepayers in anticipation of future tax liabilities. Shoreham's ratepayers (like all other utility ratepayers) were asked to pay Shoreham's anticipated income taxes in rates not at Shoreham's actual tax costs, but at the tax rates that would apply if Shoreham was not authorized to accelerate depreciation of certain assets. At the time of the collection, Shoreham knew that the funds were advanced contributions from ratepayers to be held for future liabilities. This basic fact that the ADIT represents customer funds is unchanged now that it is apparent that the future liability has now been reduced or eliminated. Accordingly, we reject Shoreham's proposal that it is entitled to keep the ADIT.

105. ADIT represents the deferred taxes that have been booked to pay future tax liabilities. To date, Shoreham has collected this amount based upon the Subchapter C tax rates we find do not apply.

We do not, however, direct Shoreham to immediately return the funds to ratepayers through amortizations. Instead, we direct Shoreham to establish a regulatory liability account equal to the difference between the current ADIT balance of $611,143 and an ADIT balance that would have been produced had Shoreham been taxed at the actual corporate income tax rate (which we find to be zero) since 1999 year-end.[106] Shoreham may either continue to keep this liability account on its books until the liability for which it was collected occurs or Shoreham may return it to ratepayers in the form of amortizations over a reasonable period of time. In addition, we want to make clear that, if Shoreham is sold, the money in the liability account should be returned to ratepayers (unless Shoreham can demonstrate an alternative means by which ratepayers can receive the full benefit of these funds).

(5) Federal Universal Service

Federal Universal Service Funds ("FUSF") are intended to support the provision of telephone service throughout rural America. During the 2002 test-year, Shoreham received $729,037 in FUSF. In its review of Shoreham's cost of service, the Department took the position that an increase of $238,931 in FUSF during the rate year was a known and measurable change. Shoreham did not rebut the Department's testimony and recommendation to adjust revenues upward. Based on the record evidence and agreement between the parties, the Hearing Officer recommended FUSF revenue of $967,968, an increase of $238,931.

The Department conducted a thorough review of Shoreham's cost of service. Following extensive prefiled testimony, several days of technical hearings, submission of briefs and oral argument, we are now in a position to decide Shoreham's rates. In its comments on the Proposal for Decision, Shoreham now claims for the first time that FUSF revenue increased by only $72,638 and that the Department incorrectly double counted $166,248 in FUSF. The Department's error, according to Shoreham, was likely a result of confusion over the reallocation of funding sources from NECA's revenue pool to the Universal Service Administrative

106. Shoreham shall submit a compliance filing with the Board within 15 days from the issuance of this Order which indicates the amount of the regulatory liability account. To the extent the parties are unable to reach a consensus relative to the amount of the regulatory account, each party shall submit individual proposals with the Board within 30 days from the issuance of this Order.

Corporation's FUSF and a requirement, pursuant to the 1996 Telecommunications Act, to make implicit subsidies explicit support mechanisms. The Department has not stated that it agrees with Shoreham's assessment that it made a calculation error.

Shoreham's new assertions relative to increases to the FUSF revenues are untimely and unsupported by evidence in the record. The Department originally proposed its $238,931 upward adjustment in its prefiled testimony submitted on April 5, 2004. After that time, Shoreham had multiple opportunities to refute the Department's claims and present its own evidence. For whatever reason, Shoreham and its counsel elected not to do so during the evidentiary portion of this investigation. As the Board must base its decision on evidence in the record (3 V.S.A. § 809), we have no basis on which to modify the Proposal for Decision. Thus, the Board finds the increase in FUSF revenue to $967,968 to be a known and measurable change.

(6) Local Measured Service

The Proposal for Decision includes a downward adjustment of $7,000 in Local Measured Service ("LMS") revenue. The Hearing Officer concluded that there has been a reduction in the number of second lines which was likely to produce a reduction in LMS revenues.

In its comments on the Proposal for Decision, the Department maintains that the weight of the evidence does not support the conclusions reached by the Hearing Officer. According to the Department, Shoreham presented testimony of a $7,000 drop in LMS revenues during 2003. The Department asserts that there is no evidence to show that this one-time event represents a trend that would justify continuing the revenue reduction to 2004.

In our judgement, a $7,000 adjustment in LMS revenues is known and measurable. The record evidence indicates that LMS revenue and the number of second lines declined during 2003. Although we cannot conclude that this change represents a trend, it is a more recent reflection of the number of lines that Shoreham serves, and thus is more likely to represent the conditions of service in the adjusted test year. We also note the Hearing Officer's recommendation is supported by general industry trends which indicate that the increasing use of wireless, cable modems and broadband facilities is contributing to declining regulated revenues for ILECs (although some of this decline is offset by increasing non-regulated revenues). There is no reason to believe that Shoreham is immune from these industry trends. We find that the $7,000 reduction in LMS is just.

(7) Inclusion of Non-regulated Revenue

In its comments on the Proposal for Decision, Shoreham asserts that the Hearing Officer "appears to have inadvertently included $66,712 of non-regulated revenue in his 'total company' revenues." As a remedy to this purported error, Shoreham requests the Board to eliminate non-regulated revenues for the purpose of setting rates. The Company did not, however, cite to where in the Proposal for Decision and supporting schedules this error existed, nor did it explain the nature of the purported error.

After further review of the record evidence, we find that the Hearing Officer's recommendation properly accounts for all regulated and non-regulated revenues. Absent an explanation by Shoreham that clearly shows the accounting for this revenue, we cannot accept the request to make further revenue adjustments.

(8) Allocation of Executive Compensation to Non-Regulated Operations

The Hearing Officer found that an increase of $109,999 in Corporate payroll and benefit expenses was reasonable. He concluded that such an increase will bring executive salaries up to levels similar to those of executives of similarly-sized ILECS, with similar responsibilities and experience as the current executives/owners of Shoreham. We concur with the Hearing Officer's recommendation.

In its comments on the Proposal for Decision, the Department noted, however, that the Proposal for Decision did not allocate a portion of the salary increase to non-regulated operations. For the sake of consistency, according to the Department, the Board should allocate 7.4% of the proposed increase to non-regulated operations, just as other expense items were allocated when such expenses could not be directly assigned to non-regulated operations. This recommendation is reasonable and consistent with the rest of this Order. Therefore, we allocate a portion of the increased salary expense to non-regulated operations in a manner that is consistent with the allocation of similar expense items. Assigning 7.4% of the salary increase that we accept reduces the amount of regulated expenses by $8,140.

(9) Rate Case Expense

In its comments on the Proposal for Decision, Shoreham notes that the Hearing Officer has not established a process for determining the Company's rate case expenses in this proceeding, or for amortizing those expenses over time. Shoreham avers that its rate case expenses will be substantial and requests the Board for leave to submit a compliance filing which would specifically identify the amount of the expenses incurred in this proceeding and propose an amortization schedule for recovering those expenses.

Rate case expenses are a legitimate cost of service and are therefore subject to recovery from ratepayers. The mechanism for recovering rate case expenses that the Board has typically employed is to average them with similar expenses that have been incurred over a three to five year period. In this manner, rate case expenses are normalized and rates levelized over a longer period of time. Otherwise, rates would fluctuate widely from year to year depending on the nature of individual proceedings before the Board. Shoreham's request to submit a compliance filing to recover its rate case expenses in this proceeding is a departure from past Board practices. Although we recognize that Shoreham's rate case expenses in this proceeding may be substantial, we do not find that a departure from past practices is warranted at this time. Additionally, Shoreham's present rate case expenses have not been submitted as record evidence so neither the Board nor the Department have had the opportunity to review them and determine their reasonableness.

Notwithstanding the above, Shoreham should recognize that there are certain past rate case expenses that are included in test year expenses that, unless adjusted here by known and measurable changes, will flow forward into the rates that we set here. Also, because the Board has the policy of normalizing regulatory expense over a five-year time period, Shoreham will have the opportunity to recover its prudently incurred expenses for this rate case if the Board re-examines the Company's rates within this period.

C. Conclusion

We close with one final observation. Whatever the strains of this proceeding, one very favorable result will occur. The average customer will see savings in their phone bills in January of 2005, August of 2005, and January of 2006. By 2006, Shoreham's customers will see average rate reductions of about $340 per year.[107] This should be a very positive economic development for them, for all of Vermont, and particularly for citizens and local businesses in Rutland and Addison counties. We look forward to the parties' proposed rate designs for bringing this value to Shoreham's customers.

VIII. Order

It Is Hereby Ordered, Adjudged and Decreed by the Public Service Board of the State of Vermont that:

1. Except as amended herein, the Findings, conclusions and recommendations of the Hearing Officer are adopted.

2. Shoreham Telephone Company, Inc. ("Shoreham" or "Company") shall reduce its intrastate revenues by $1,268,459. This revenue reduction shall be implemented in three equal rate reductions as follows: the first third by January 1, 2005; the second third by August 1, 2005; and the final third by August 1, 2006.

3. Shoreham shall, after consultation with the Vermont Department of Public Service, file revised intrastate tariffs with the Public Service Board, within 15 days of this Order, to incorporate this reduction in its rates. Shoreham shall also propose specific rate reductions for the second and third phase at this time. The Department shall file comments within 15 days of receipt of Shoreham's proposal. The Board will open an investigation of this tariff filing upon receipt.

4. Shoreham shall establish a new regulatory liability account equal to the difference between the current accumulated deferred income taxes ("ADIT") balance of $611,143 and the ADIT balance that would have been produced had Shoreham been taxed at the actual corporate income tax rate since 1999 year-end. Shoreham may either continue to keep this liability account

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107. $1,268,450 reduction for 3707 lines.

on its books until the liability for which it was collected occurs or Shoreham may return it to ratepayers in the form of amortizations over a reasonable period of time. Shoreham shall make a compliance filing, within 45 days of the date of this Order, that shows the recalculated ADIT and any proposed amortization period. Any party who wishes to comment on Shoreham's compliance filing shall do so within 30 days of the Company's filing.

Dated at Montpelier, Vermont, this 4th day of November, 2004.

s/Michael H. Dworkin	PUBLIC SERVICE
s/David C. Coen	BOARD
s/John D. Burke	OF VERMONT

OFFICE OF THE CLERK

FILED: November 4, 2004

ATTEST: s/Susan M. Hudson
Clerk of the Board

NOTICE TO READERS: This decision is subject to revision of technical errors. Readers are requested to notify the Clerk of the Board (by e-mail, telephone, or in writing) of any apparent errors, in order that any necessary corrections may be made. (E-mail address: Clerk@psb.state.vt.us)

Appeal of this decision to the Supreme Court of Vermont must be filed with the Clerk of the Board within thirty days. Appeal will not stay the effect of this Order, absent further Order by this Board or appropriate action by the Supreme Court of Vermont. Motions for reconsideration or stay, if any, must be filed with the Clerk of the Board within ten days of the date of this decision and order.