BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition of Citizens of the State of Florida for a limited proceeding to reduce General Telephone Company of Florida's authorized return on equity	DOCKET NO. 870171-TL
In re: Investigation into the proper application of Rule 25-14.003, F.A.C., relating to tax savings refunds for 1988 and 1989 for GTE Florida Incorporated	DOCKET NO. 890216-TL ORDER NO. 22352 ISSUED: 12/29/89

The following Commissioners participated in the disposition of this matter:

MICHAEL McK. WILSON, Chairman
THOMAS M. BEARD
BETTY EASLEY
GERALD L. GUNTER
JOHN T. HERNDON

APPEARANCES:

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BY THE COMMISSION:

FINAL ORDER

I. BACKGROUND

Docket No. 871206-PU is a generic docket that was opened to investigate the 1988 effects of the Tax Reform Act of 1986 (the Act) on all utilities under our jurisdiction. At the Agenda Conference on December 1, 1987, Staff recommended that we order a portion of each utility's 1988 revenues be collected subject to refund pending the outcome of this investigation. We deferred action then until the utilities had an opportunity to offer an alternative protection to their ratepayers.

On December 8, 1987, GTE Florida Incorporated (GTEFL) sent us a letter (the Commitment Letter) in which it committed to make the 1988 effects of the Act retroactive to January 1, 1988, pursuant to the terms of the letter. By Order No. 18661, issued January 7, 1988, we accepted GTEFL's commitment and excluded the company from any requirement that revenues be collected subject to refund. By Order No. 20269, issued November 7, 1988, we proposed to adopt a cap of 14.25% on the 1988 and 1989 earnings of GTEFL. We stated there that GTEFL would be excused from further participation in Docket No. 871206-PU if the Proposed Agency Action were to become final.

The Office of Public Counsel (OPC) and the Florida Consumers for Responsible Utilities (FCRU) filed protests to Order No. 20269 on November 22, 1988. On December 27, 1988, GTEFL moved to strike these protests, arguing that OPC and FCRU were improperly attempting to place return-on-equity (ROE) and earnings matters at issue in the generic investigation dealing with tax matters. OPC responded on January 9, 1989, asserting that its suggested ROE and earnings issues are relevant to the application of Rule 25-14.003, Florida Administrative Code (the Tax Rule), which establishes procedures for dealing with changes in the corporate income tax laws.

On January 20, 1989, GTEFL amended its motion, claiming that the company has returned to its ratepayers the savings it realized from the Act and that any action in Docket

No. 871206-PU forcing it to dispose of additional revenues would expose it to "double jeopardy." GTEFL also moved for the establishment of a two-phase procedural process under which, first, the company's action with regard to its tax savings could be considered, and second, a prospective ROE could be set for GTEFL. OPC filed its response to GTEFL's pleading on January 31, 1989, quarreling with the company's allegation that its tax savings have been "given back" to its customers.

By Order No. 20800, issued February 23, 1989, the Prehearing Officer denied GTEFL's motions to strike and rejected its proposed procedural process. Order No. 20800 held that all issues which led us to open Docket No. 871206-PU need to be resolved and that their consideration is the proper focus of the generic investigation, including ROE and earnings issues which are fundamental to this proceeding. The only issues rejected by Order No. 20800 as falling outside the scope of this proceeding were those dealing with the events (e.g., GTEFL's offer of a cap on earnings) that led up to the action proposed in Order No. 20269.

On October 20, 1988, OPC served a request for production of documents on GTEFL, and on December 9, 1988, GTEFL filed a response and objection to this request. OPC filed a motion to compel on December 13, 1988, and GTEFL responded on December 27, 1988. By Order No. 20799, issued February 23, 1989, the Prehearing Officer compelled GTEFL to produce for inspection the documents sought by OPC. Judgement was reserved in Order No. 20799 on the question of the appropriate treatment to be afforded these documents in the event that OPC seeks to take possession of copies of them.

On March 6, 1989, GTEFL filed separate motions for review of Orders Nos. 20799 and 20800 by the full Commission. GTEFL argued that ROE, capital structure and 1988 and 1989 earnings issues are irrelevant to this proceeding and should have been striken by the Prehearing Officer. According to GTEFL, the Commission should decide the legal question involving its "double liability" argument before considering any factual issues. Similarly, the company complained that it should not have been compelled to produce documents sought by OPC which relate to cost of equity and earnings because they are irrelevant. Also on March 6, 1989, OPC filed a motion for reconsideration of Order No. 20800, charging that issues involving the action proposed in Order No. 20269 were improperly excluded from consideration in this proceeding by Order No. 20800. By Order No. 21208, issued May 9, 1989, we denied these motions for review and reconsideration and affirmed Orders Nos. 20799 and 20800.

By Order No. 20857, issued March 6, 1989, we transferred the protests to Docket No. 890216-TL, which was set up to deal with GTEFL specifically, and excused the company from further participation in Docket No. 871206-PU. OPC and FCRU were granted party status in Docket No. 890216-TL.

Several of the issues addressed in the protests had been raised previously by OPC in a petition seeking a limited proceeding to reduce GTEFL's authorized ROE. Docket No. 870171-TL had been opened to resolve the issues raised in that petition. By Order No. 19637, issued July 8, 1988, we required GTEFL to answer OPC's petition, and on July 18, 1988, GTEFL filed its answer. Because of the apparent overlap of issues raised in the protests and in the petition, Order No. 20857 consolidated Dockets Nos. 870171-TL and 890216-TL into a single proceeding.

In a February 10, 1989 letter to us, GTEFL committed to a January 1, 1989 effective date for our resolution of the 1989 effects of the Act pursuant to the terms of the letter. By Order No. 20857, we accepted this commitment as being adequate protection for ratepayers in lieu of taking other action, e.g., ordering GTEFL to hold revenues subject to refund. Apart from accepting the company's offer to accept a retroactive application of our action in these consolidated proceedings, Order No. 20857 took no position on the arguments advanced by GTEFL in its February 10th letter.

In Order No. 21369, issued June 12, 1989, the Prehearing Officer established the prehearing procedure to govern this proceeding and adopted a tentative list of 13 issues to be addressed. On June 26, 1989, OPC moved to amend Order No. 21369 by substituting a list of 26 issues in place of the tentative list. In OPC's view, this proceeding had become disorganized and would remain so unless the requested action was taken.

GTEFL responded on July 7, 1989, opposing OPC's motion to amend and requesting that bifurcated hearings be held. The company alleged that it would be prejudiced by the disruption occasioned by a substitution of issues and that OPC's proposed issues would expand and complicate the proceeding. GTEFL suggested that the disorganization noted by OPC could be cured if we would establish a two-phase proceeding.

By Order No. 21757, issued August 21, 1989, the Prehearing Officer denied OPC's motion to amend Order No. 21369 and GTEFL's motion to hold bifurcated hearings. On his own motion, the Prehearing Officer deleted two issues from the tentative list because they were duplicative and did not conform to Orders Nos. 20800 and 21208 since they involved matters that led up to the action proposed in Order No. 20269.

Prehearing Statements were filed by GTEFL, OPC and Staff on August 21, 1989. On September 1, 1989, GTEFL, OPC and Staff stipulated to a new list of 19 issues and thereafter filed revised Prehearing Statements addressing these issues. FCRU has filed neither an original nor a revised Prehearing Statement. Four days of hearings were commenced on September 25, 1989, and 11 witnesses testified. FCRU did not participate in the hearing or file a brief.

II. LEGAL ISSUES

A. OPC's Objections:

OPC has objected to portions of the following late-filed exhibits filed by GTEFL: Original 71 (LF 71), 75 & 76 (LF 75&76) and 82 (LF 82). With its Brief, OPC filed an Exhibit Objection (the Objection), claiming that portions of LF 75&76 are erroneous and understate expenses. OPC argues that certain documents, which it appends to its Brief, demonstrate that higher hourly rates were applied than those shown on these exhibits. The Objection questions the accuracy of the expenses for Home Shopping Network (HSN) litigation and sports marketing claimed by GTEFL and requests that the disputed portions of the late-filed exhibits be rejected.

The Objection also maintains that LF 71 is not shown in the surveillance report format required by the Commission and contains an adjustment for other operating tax that is not supported by the record. The Objection complains also that LF 71 has an intercompany tax elimination which purports to decrease net operating income rather than to reduce revenue requirements as OPC believes proper.

On November 30, 1989, GTEFL filed a Response to the Objection (the Response), maintaining that these late-filed exhibits should be received in evidence over OPC's objection. The Response complains that OPC requested that GTEFL submit LF 75 and now seeks to prohibit its becoming part of the record of this proceeding. Moreover, GTEFL objects to OPC's "improper tactic" of seeking to use documents which are not sponsored by witnesses, thereby violating the company's due process rights by failing to lay a foundation for their use in the proceeding. With respect to LF 75&76, the company alleges that these exhibits are not rendered erroneous by the documents referred to by OPC, which are not part of the record. According to GTEFL, the information shown in these documents is not comparable because they are contracts between GTEFL and a non-regulated affiliate which do not reflect the fully-loaded labor rate that is incorporated in LF 75&76. The contract rate includes indirectly attributable costs and unattributable costs as well as a fully-loaded labor rate.

Regarding LF 71, GTEFL argues that it was given the choice of presenting these data in a surveillance report format or in another format. It first elected to present them in another format in original LF 71 and then submitted them in the surveillance report format in its Supplemental Responses to that exhibit (LF 71S). In LF 71S, GTEFL asserts that the other operating tax adjustments and the intercompany tax elimination adjustment are explained. Additionally, the company believes that the record contains support for the latter adjustment. The Response asks that these three exhibits be received into evidence and that the Objection be denied.

OPC submitted a letter dated November 29, 1989, addressing its objection to LF 71 in light of the submission of LF 71S. OPC clarifies that its objection to LF 71 should have been a partial objection. OPC acknowledges that, through the submission of LF 71S, GTEFL has cured OPC's concern that LF 71 was not prepared in the surveillance report format. However, OPC points out that LF 71S does not incorporate any adjustment with which the company does not agree. OPC states that its objection to LF 71 was that the intercompany tax adjustment appeared in brackets, indicating that net operating income (NOI) should be decreased, whereas OPC believes that such an out-of-period and "local only" adjustment should increase NOI. Finally, OPC withdraws its objection to that portion of LF 71 with respect to the other operating tax adjustment of $1.8 Million, although OPC does not believe that this adjustment is adequately supported in the record.

In a November 27, 1989 letter, OPC objects to that portion of LF 82 which refers to reorganization costs charged to the company by GTE Service Corporation (GTESC). A company witness testified that all such costs have been eliminated and agreed to provide a late-filed exhibit to indicate whether any of GTESC's costs relating to the reorganization had been allocated to GTEFL. OPC points out that LF 82 identifies $278,634 of intrastate reorganization costs allocated to GTEFL from GTESC and states that "this amount is removed in the company's general services and licenses adjustment on the surveillance report." OPC alleges that its review of the company's surveillance report workpapers does not support the allegation made in LF 82. OPC contends that the adjustment from the last rate case of $1,756,000 (6.64% of general services and licenses costs of $26,444,000) contains only $18,407.29 or 6.64% of the $278,634 amount. It thus appears to OPC that an additional $260,233 should be added to the company's 1988 achieved earnings.

On December 5, 1989, GTEFL submitted a letter responding to OPC's November 27th letter in which the company refutes OPC's allegation. GTEFL asserts that we have never identified the reasons or activities to which this adjustment should apply and states that: "It is the company's position that the [reorganization costs] are contained within the $1,756,000." For this reason, GTEFL believes that OPC's proposed adjustment should be rejected.

Our practice has been to accept all late-filed hearing exhibits subject to an objection being raised by a party. In view of the objections raised by OPC, we shall sustain them as a matter of due process. Admitting the contested portions of these four late-filed hearing exhibits would be error because they are subject to factual dispute, and as such, OPC has not had the opportunity to contest GTEFL's factual assertions. The Objection will be sustained for this reason, and the controverted portions of LF 71, LF 75&76 and LF 82 will be striken. Since no objection has been raised to LF 71S, it will be accepted in accordance with our normal procedures.

B. GTEFL'S Motion To Strike:

On November 30, 1989, GTEFL filed a Motion to Strike (the Motion) portions of OPC's Brief. The Motion complained that OPC has violated the Prehearing Order, the Administrative Procedures Act and the company's due process rights as well as denying the company a fair hearing through tactics employed in presenting its case in this proceeding. GTEFL said that OPC consistently presented documents at the hearing without any sponsoring witnesses or foundations which prevented the company from learning of the purpose of the document. OPC's Brief now seeks adjustments, according to GTEFL, based on these exhibits and on cross-examination about them in the record without notifying the company that the matters are at issue.

GTEFL alleges that OPC has violated Rule 25-22.038, Florida Administrative Code, by failing to disclose all issues before hearing, except for certain accounting issues that were included in the Prehearing Order. Citing Section 120.57, Florida Statutes, GTEFL claims that it has a statutory right to be put on notice as to issues in a proceeding as well as to respond and present evidence and argument concerning them.

Specifically, the Motion asks that the following matters addressed in OPC's Brief be striken: (1) the allegation that GTEFL did not disclose fully to Staff auditors that "Blue Back points" had been issued by Arthur Andersen & Co.; (2) the reference to Home Shopping Network (HSN) litigation expenses dealing with internal employee expense and the utilization of outside legal expenses as a surrogate as well as to the claim that the company should receive no recoupment for litigation expenses; (3) a proposed adjustment for 1987 central office equipment retirements; (4) the discussion of a proposed adjustment for 1987 inventory; and (5) a proposed disallowance for all rent expense for One Tampa City Center.

After considering the allegations, we will deny the Motion. We believe that the action requested by GTEFL is too draconian to fit the alleged offense. Instead, we will accept OPC's Brief, and in making our decision in this Order, we have accorded the portions contested by GTEFL the weight that we deem to be appropriate.

C. <u>ROE Authority</u>:

GTEFL argued that Order No. 18661, issued December 8, 1987 (the Order), does not allow the application of a new ROE for the purpose of implementing the Tax Rule during 1988. In the company's view, the Order merely incorporates GTEFL's agreement to a January 1, 1988 effective date for the disposal of the tax savings associated with the Act independent of the Tax Rule. GTEFL said that it never agreed in any way to the establishment of a new ROE for retroactive application to January 1, 1988. The Order resulted from a process initiated by our Staff who requested GTEFL to make the 1988 effects of the Act retroactive to January 1, 1988. The company believes that the purpose of Staff's letter was to allow the necessary time to resolve the situation while protecting the interests of the ratepayer. GTEFL stated that it agreed to a January 1, 1988 effective date due to its understanding that the purpose of Staff's request was to create a situation where the tax savings would be disposed of independent of the Tax Rule.

GTEFL relied on the explicit language contained in the Commitment Letter, in which GTEFL can find no agreement to the retroactive application of a new ROE for purposes of the Tax Rule. Rather, GTEFL expressly stated its understanding that it was agreeing to a procedure where the Commission would act independent of the Tax Rule. GTEFL only committed to dispose of "incremental dollars" which were not permanently disposed of in the 1987 settlement regarding the Act by Order No. 17382. GTEFL argued that it reserved all options regarding the appropriate use of the tax savings which would not have been possible under the Tax Rule and pointed out that this position was never disputed.

In support of its position, GTEFL cited the following factors: (1) the Order does not state that it is our intent to establish a new ROE for retroactive application to January 1, 1988, for use in the Tax Rule; (2) the Order was unnecessary if we wanted to apply the Tax Rule directly; (3) the retroactive application of a new ROE is inconsistent with the terms of the Tax Rule; (4) GTEFL had filed a Motion to Dismiss which alleged that we cannot adjust a ROE in a vacuum without its consent; (5) we did not apply the Tax Rule to GTEFL in 1987 as evidenced by the language in Order No. 17382; (6) the retroactive application of a new ROE would subject GTEFL to double liability; and (7) we did not apply the Tax Rule to various other utilities.

It is GTEFL's position that, for the company to be subject to the retroactive application of a new ROE to January 1, 1988, there must be a clear, knowing and voluntary agreement on its behalf to such a proposal. GTEFL said it never had any idea that it was our intent to take such action when the Order was issued; therefore, there was never the required "meeting of the minds" on the terms when GTEFL issued the Commitment Letter.

OPC argued that the Order reserved jurisdiction to use a January 1, 1988 effective date for any resolution of this docket. In OPC's opinion, GTEFL also consented to the use of a January 1, 1988 effective date for any resolution of this docket. Recommendations filed by our Staff preceding the issuance of the Order made it clear that the obsolete ROEs of many companies motivated us to gain GTEFL's consent to a January 1, 1988 effective date for any resolution of the tax savings issues during 1988.

We confirm that our intent in accepting the Commitment Letter included the possible option of employing an ROE that is based on current market conditions in lieu of the authorized ROE in applying the Tax Rule to GTEFL's 1988 revenues. In discussing the events which led the company to submit the Commitment Letter, GTEFL argued that our negotiating for ratepayer protection led to "a contractual agreement." The company maintained that it made an offer which we accepted, and accordingly, the Commitment Letter binds us and the company by "its express terms and conditions." This attempt to interject common law principles of contract law into the regulatory process must fail.

The fatal flaw in the company's argument is that we do not possess the legal capacity of a private party to enter into contracts covering our statutory duties. Indeed, we cannot abrogate -- by contract or otherwise -- our authority to assure that our mandate from the Legislature is carried out. As a result, we may not bind the Commission to take or forego action in derogation of our statutory obligations. As a result, GTEFL is unable to argue successfully that we are bound by each term and condition of the Commitment Letter under contract law principles relating to an offer's acceptance.

Our intent in adopting the Order defines the action that may be taken in this proceeding and not the terms and conditions of the Commitment Letter. For this reason, we reject GTEFL's argument that common law principles of contract law are applicable to our acceptance of the Commitment Letter. This finding also covers the "detrimental reliance" argument advanced by the company; the same legal incapacity which prevents us from entering into bilateral contracts prohibits us from becoming a party to a unilateral contract.

GTEFL contends that there was no "meeting of the minds" on the issue of whether a new ROE may be used in applying the Tax Rule because the events which led to its submission of the Commitment Letter did not notify the company of this possible outcome. Lacking this knowledge, GTEFL says it could not have expressly consented to our establishment of a new ROE, which the company claims to be a prerequisite to our authority. In the company's view, since its consent was necessary and it had no notice upon which to base a consent, we lack authority outside of a full rate proceeding to apply the Tax Rule using any ROE other than the currently authorized ROE.

Based on Staff's recommendation filed in Docket No. 871206-PU on November 17, 1987, we believe that GTEFL had adequate notice that ROEs were too high for some utilities and that, unless those utilities would agree to accept reasonable ROEs for application of the Tax Rule, we believed that this rule could not be effectively applied to protect ratepayers' interests. We acted upon this recommendation by giving the utilities time to submit letters committing to a January 1, 1988 effective date for action on tax savings in lieu of setting revenues subject to refund. GTEFL availed itself of this opportunity and submitted the Commitment Letter.

It is our intention in accepting the Commitment Letter which determines whether an ROE based on market conditions can be used in applying the Tax Rule. In our opinion, the best extrinsic evidence of our intent is the Order which clearly states: "[t]he following telephone companies have sent letters to us offering not to contest a January 1, 1988 effective date <u>for any resolution of this docket</u>: . . . 2. General Telephone Company of Florida;. . .." [Emphasis supplied]. Our conclusion that GTEFL understood the breadth of our intent appears entirely reasonable in view of the clear language of the Order and the company's decision not to seek reconsideration of it. If GTEFL did not agree to a January 1, 1988 effective date for any resolution, the company was obligated to seek clarification or reconsideration of the Order.

A GTEFL witness testified that the Commitment Letter was not a "blank check," and we agree. We recognize that we are bound by statutory limitations and by due process obligations; however, we believe that we can apply the Tax Rule using a reasonable ROE to GTEFL's 1988 revenues without exceeding our legal authority or denying the company due process.

We had the authority in late 1987 to conduct proceedings to establish reasonable ROEs, based on then-current market conditions, for those utilities whose ROEs were too high. The decision made here cannot be construed as an effort to expand our authority beyond that which existed in late 1987. We reject GTEFL's theory that a telephone company's ROE may be changed without its consent only through a full rate proceeding. In our opinion, we had in late 1987 and now have limited proceeding authority pursuant to Section 364.14, Florida Statutes. Additionally, the Rate Stabilization Proceeding involving Southern Bell Telephone and Telegraph Company (Bell), Docket No. 880069-TL, stands for the proposition that such action can be taken in less than a full rate proceeding. Had such a proceeding been conducted in this case in late 1987, no further action would have been necessary to protect ratepayers' interests in GTEFL's 1988 revenues because the Tax Rule would have operated effectively to perform that function.

However, we elected to take alternative action -- acceptance of the Commitment Letter -- in order to accomplish the same result, protecting 1988 revenues, without holding a hearing that was not deemed necessary. For these reasons, we believe that our acceptance of the Commitment Letter immunizes our action here against retroactive ratemaking in light of our intent that the establishment of a new ROE for Tax Rule purposes was a possible option in disposing of GTEFL's 1988 tax savings.

GTEFL's due process rights have been amply protected through its full opportunity to participate in this proceeding. It is abundantly clear to us from the record that the company not only intended to avoid issuing us a "blank check" but also sought to severely circumscribe our range of action. However, as we have explained, the company's intent is not definitive of our powers or our intent. For these reasons, we confirm that we intended, as a possible option, to apply the Tax Rule using an ROE based on current market conditions to GTEFL's 1988 revenues when we accepted the Commitment Letter.

D. <u>Capital Structure Authority</u>:

GTEFL similarly argued that the Order does not allow the application of a new capital structure for the purpose of implementing the Tax Rule during 1988. In addition, GTEFL submitted that the adverse parties are misinterpreting the Commitment Letter and the Order since neither mentions capital structure issues. The company believes that the adverse parties are taking a January 1, 1988 effective date to include any type of adjustment which produces the result they desire. To suggest that it agreed to a January 1, 1988 effective date so that the "double leverage" concept could be raised in this proceeding, in the company's view, is contrary to the facts and circumstances existing at the date of the Order.

OPC maintained that the Order reserved jurisdiction to use a January 1, 1988 effective date for any resolution of this docket. In OPC's opinion, GTEFL also consented to the use of a January 1, 1988 effective date for any resolution of this docket. OPC alleged that this leaves open the issue of the company's proper capital structure just as it does the issue of its appropriate ROE.

We confirm that our intent in accepting the Commitment Letter included the possible option of imputing a capital structure different than the one authorized for the company in applying the Tax Rule to 1988 revenues. In asserting that the Commitment Letter was a contractual arrangement, GTEFL relies on its argument that common law principles of contract law should be grafted onto the regulatory process. For the reasons set out above, we reject this argument. The legal rationale supporting our decision concerning the use of a new ROE in applying the Tax Rule applies with equal force to our finding here that a different capital structure may be imputed in applying the Tax Rule to GTEFL's 1988 revenues.

At the time of accepting the Commitment Letter, we were aware of capital structure imbalances which, unless corrected, could lead to inadequate refunds of tax savings under the Tax Rule. Since we intended to use a different capital structure as a possible option in disposing of tax savings when we accepted the Commitment Letter, we may lawfully exercise this option consistent with the company's commitment without engaging in retroactive ratemaking.

E. Quad Block Property & One Tampa City Center:

OPC raised issues at the hearing regarding when and to whom GTEFL sold the Quad Block property, who constructed One Tampa City Center on that land, who leases office space in that building to GTEFL, and other related matters. In response to these issues, we directed our Staff auditors to investigate GTEFL's transactions relating to this property. The preliminary stage of this audit has been completed, and Staff has issued its audit report regarding the sale of the Quad Block property by GTEFL. This report identifies matters that require further investigation, *i.e.*, the destruction of records and the accuracy of the property appraisal made when the land was sold by GTEFL.

In its Brief, OPC argued that adjustments should be made to GTEFL's 1988 surveillance report to impute a gain on the sale of the Quad Block property and to disallow rent expenses for One Tampa City Center. In its Brief, GTEFL did not address these issues; however, based on its argument and testimony at hearing, we interpret the company's position as being that no adjustment should be made for either matter.

Judgment will be reserved on the adjustments proposed by OPC, and these dockets shall be held open pending the completion of our investigation into these matters. Based on the lack of record evidence and the pending status of our investigation, we are not now prepared to make a decision on these transactions. By leaving these dockets open until this investigation is finished, we may take action later in this proceeding that could involve an additional disposition of GTEFL's 1988 tax savings.

Further, Staff has not yet completed its research into the prior regulatory treatment of the Quad Block property and its possible impact on our ability to take action in the event that an adjustment is deemed appropriate. As a means of assisting us in this endeavor and in order to focus this issue properly, we direct GTEFL and OPC to submit briefs by January 12, 1990, on the legal question of whether we are now precluded from making an adjustment found appropriate with respect to GTEFL's activities in connection with its sale of the Quad Block property by any legal impediment arising from the company's accounting practices or the property's treatment in prior proceedings. The briefs should focus on the following issue:

> Is the Commission now precluded from making an adjustment found appropriate with respect to GTEFL's activities in connection with its sale of the Quad Block property by any legal impediment (e.g., administrative finality, res judicata, stare decisis or collateral estoppel) arising from the company's accounting practices or the property's treatment in prior proceedings?

Following its review of the briefs and upon the completion of its legal research and the parties' discovery, our Staff is directed to prepare a recommendation as to the appropriate action, if any, regarding the gain on sale of land for our consideration.

III. 1988 EARNINGS

A. Earnings under the Tax Rule:

GTEFL maintained that we should accept its earnings as set forth on its surveillance report for 1988. GTEFL claimed that it never agreed to being involved in a rate case in which the presentation of detailed accounting adjustments and double leverage presentations would be involved. GTEFL's reported earnings should only be subjected to adjustments made in its last rate case, according to the company, and new adjustments are improper and beyond the scope of this proceeding.

OPC believes that the company should be allowed all reasonable, prudently-incurred 1988 expenses when we determine the company's earnings for 1988. We should not accept at face value the surveillance report prepared by GTEFL, in OPC's view, without reviewing the reasonableness and propriety of the expenses included in the report.

Our Staff contended that the earnings to be established in applying the Tax Rule should be examined for prudence and reasonableness, and where appropriate, adjustments should be made. Such adjustments include, but are not limited to: (1) those made in the company's last rate case, (2) out-of-period items, (3) improper jurisdictional allocations, (4) non-regulated expenses or allocations, and (5) errors and mistakes.

We accept our Staff's recommendation that some adjustments to GTEFL's 1988 earnings be made. We have reviewed various changes proposed by the company and certain of these will be approved. Moreover, Staff has analyzed the adequacy of the earnings by reviewing the record relating to the appropriate capital structure and the cost of capital. We adopt Staff's determination of the earnings attributable to 1988 and the capital costs required in 1988.

B. Achieved ROE:

GTEFL proposes that its 1988 surveillance report should be adjusted by $1,426,000 on an NOI basis, which includes a decrease in NOI for Franchise Taxes. The company's rate base should be increased by $5,187,000, in GTEFL's opinion. Accordingly, GTEFL believes that its adjusted achieved return on equity would be 13.99%.

OPC recommends that the company's 1988 surveillance report should be adjusted by $29,213,000 on an NOI basis. The consolidated capital structure for the GTE companies should be used, according to OPC, with a ROE of 12.75%. Rate base should be increased by $4,315,000. OPC calculates that these adjustments would bring GTEFL's achieved ROE to 21.91%.

We approve several adjustments, which are explained below, to GTEFL's earnings reported on its 1988 surveillance report. In summary, these adjustments are: (1) the company's NOI is increased by $3,600,000; (2) its rate base is increased by $3,148,000; and (3) its achieved 1988 ROE is found to be 14.89%.

Our individual rulings on each earnings adjustment to GTEFL's 1988 surveillance report proposed by a party will be addressed below on an item-by-item basis.

1. Sports Events:

OPC and our Staff recommended that an NOI adjustment of $131,659 be made to remove expenses for the 1988 GTE Sun Coast Golf Classic, the 1988 World Challenge of Tampa and the 1988 St. Petersburg Grand Prix. GTEFL opposed this adjustment. We approve this adjustment which will result in a decrease in intrastate expenses of $211,093. In our judgment, these amounts should not be paid for by ratepayers because they involve a type of image or goodwill advertising. GTEFL's position that they represent selling expenses was not supported by any evidence in the record; therefore, these amounts shall be removed from regulated expenses.

2. Tampa Stadium Sky Box:

The record reflects that $29,144 in expenses were associated with sky box expenditures at Tampa Stadium and $5,138 in expenses for tickets. OPC and our Staff recommended that an NOI adjustment of $18,177 should be made to remove these expenses, and GTEFL opposed this adjustment. We approve this adjustment which will increase GTEFL's NOI by $18,177. In our judgment, these amounts should not be paid for by ratepayers because they are not justified by any evidence in the record; therefore, these amounts shall be removed from regulated expenses.

3. Unfunded Pension Expense:

OPC proposes that an NOI adjustment of $2,810,000 should be made to GTEFL's 1988 surveillance report to eliminate unfunded pension expense. In support of this adjustment, OPC cites the proceeding involving Florida Power & Light Company's (FP&L) 1987 tax savings in which we accepted the funded amount of Zero rather than the negative expense of $22.5 Million which had been accrued pursuant to Statement of Financial Accounting Standards No. 87 (SFAS 87). GTEFL's view on this adjustment is that we should recognize the pension expense as accrued on the company's books and reject OPC's proposal.

We will not approve this adjustment. We find that the holding in the FP&L case does not apply in this proceeding for two reasons. First, FP&L recorded a regulatory liability in the amount of $22.5 million in 1987 to offset the negative pension expense derived under SFAS 87. This resulted in a net accrual on that company's books of zero which was equal to the amount funded for the year. In reviewing that action, we decided not to change the amount that was actually recorded by FP&L during the year for pension expense. By contrast, the record here reflects that GTEFL recorded pension expense of $4,400,000 in 1988 but did not record an offsetting regulatory asset to reflect the zero funding. Therefore, by making an adjustment to GTEFL's 1988 surveillance report here, we would be violating our objective in the FP&L case of imposing new accounting policies prospectively and not retroactively.

The method for pension accounting authorized for FP&L is not appropriate for GTEFL because, for telephone companies, we adopted Rule 25-4.017, which approves the Uniform System of Accounts adopted by the Federal Communications Commission that incorporates SFAS 87's method of accounting for pension expense. This method was used by GTEFL during 1988. The proposed adjustment is inconsistent with our rules, and until another method of pension accounting is adopted, telephone companies should record pension expense in accordance with Rules 25-4.017.

4. <u>Deferred Compensation for Directors</u>:

GTEFL recorded a 1988 expense of $178,000, on a total company basis, for the increased value of stock units provided as deferred compensation to some members of its board of directors. This is an estimate of a future liability based on the current market price of the stock and may increase further or decrease in future periods. There is no funding requirement involved. OPC and our Staff recommended that an NOI adjustment of $74,000 be made to remove this unfunded deferred compensation for directors. The company opposed this adjustment. We approve this adjustment which will decrease the company's intrastate expense by $118,647.

5. HSN Litigation Expenses:

GTEFL argued that only the HSN litigation expenses required to allocate 50% to the non-regulated operations, $452,755, and an out-of-period item, $134,926, should be removed. Our Staff agreed with these adjustments but believes that they did not go far enough. Staff proposed that the company's NOI should be increased by $759,000, which would decrease intrastate expenses by $1,216,931, to remove all expenses associated with this litigation.

OPC recommended an NOI adjustment of $1,209,000 to remove all HSN litigation expense, including external and internal costs. OPC's adjustment includes an amount to cover the internal costs which was arrived at by using the outside consultants' costs as a surrogate to represent the amount of internal costs. Staff found no support in the record for OPC's method of doubling the outside contractors' costs as a means of calculating a total HSN litigation adjustment.

Staff is concerned that the HSN controversy involved both GTEFL and a non-regulated affiliate. The regulated company did not keep detailed records of company participation in the litigation, including support personnel. As a result, Staff believes that GTEFL's estimate of its total costs may be understated. The company reported in an exhibit introduced at the hearing that $1,650,862 was recorded in 1988 for legal expenses, and a company witness testified that this amount represented fees paid to outside consultants. The record reflects that, apart from employees in the company's legal department, no cost record was kept for the hours spent by GTEFL employees.

Additionally, the company allocated the total costs paid to outside counsultants in prosecuting this litigation between regulated and non-regulated operations based on two ratios: first, 70/30% (70% to regulated), and then 50/50%. The record indicates that these allocation ratios were adopted by the company upon the advice of legal counsel who had analyzed the risks posed to the companies by the lawsuit. Staff is concerned that these appear to be arbitrary allocations.

Staff has reviewed material outside the record in this proceeding relating to GTEFL's total expenditures on this lawsuit. From such material, our Staff has learned that GTEFL and its affiliate have settled the lawsuit by accepting a payment of $4.5 Million from HSN. Based on its review of other such material, Staff has formed the belief that this payment may fail to cover the total amount of GTEFL's costs of prosecuting the case. If this is true, Staff recommended that these litigation expenses, the settlement receipt and the internal costs should be reported as "below the line" items because they are nonrecurring and extraordinary in scope, in the belief that the company's ratepayers should not pay for the net costs.

Because of the lack of record evidence showing the total expenses incurred by the company and its affiliate in prosecuting this litigation and the treatment of the amount received by them in its settlement, we are not now prepared to take final action on this matter. Judgment will be reserved on the HSN litigation adjustments proposed by OPC and our Staff. In light of action taken above in holding these dockets open pending the completion of our investigation into the sale of the Quad Block property and the rental of One Tampa City Center, we direct our Staff to complete its investigation into the expenses and receipts relating to the HSN litigation. At a later date, we shall make any final adjustment deemed appropriate after the results of that investigation have been considered. By leaving these dockets open pending the completion of this investigation, we may take final action later on this matter that could involve an additional disposition of GTEFL's 1988 tax savings.

While disagreeing as to the appropriate level of the 1988 adjustment for this issue, all parties are in agreement that some adjustment should be made. As a result, we believe that a preliminary adjustment should be made now based on record evidence showing the 1988 expenses for this litigation recorded by GTEFL. We approve a reduction in the company's expenses of $586,755, on a total company basis. While reserving the right to examine these expenses in greater detail when we revisit this issue at a later date, we intend that this preliminary adjustment be made now for the purpose of reducing GTEFL's expenses on HSN litigation to 50% of the total 1988 payments to outside consultants by the company and its affiliate and to exclude payments made in 1988 for 1987 services.

6. <u>Out-of-Period Billing Item</u>:

All parties agree that GTEFL's NOI should be increased by $1,107,092, resulting in an increase in intrastate revenue of $1,775,039, to remove an out-of-period item associated with a billing dispute. This adjustment concerns a billing dispute between AT&T and GTEFL relating to 1987 access charges. We approve this adjustment.

7. Out-of-Period MTS and Private Line Item:

In 1988, out-of-period revenue deductions associated with MTS "true-ups" and private line between Bell and GTEFL amounted to $837,924. An adjustment to remove this amount has been agreed to by all parties. The effect of this adjustment on GTEFL's NOI is an increase of $522,613. We approve this adjustment.

8. Out-of-Period Toll and Access Charges:

OPC initially proposed an adjustment to remove $800,000 for an out-of-period item relating to intraLATA toll messages and access charges. This amount relates to an out-of-period item concerning a dispute of 1+ messages and access charge revenue. However, OPC did not propose an adjustment for this item in its Brief. Based on our Staff's recommendation, we will not approve this adjustment because we find that this amount is part of the Out-of-Period MTS and Private Line Item dealt with above.

9. "Local Only" Adjustments:

Following the adjustments made in its last rate case, GTEFL prepared its 1988 surveillance report by removing membership fees and dues, advertising and general services and licenses on a "local only" basis, leaving the intrastate toll portion of these expenses as a regulated expense. In GTEFL's last rate case, this procedure was correct because toll expenses were pooled, and a short-cut method of recognizing the toll contribution from the pool was to include "local only" amounts. Pooling is no longer in effect, except for private line; therefore, we believe the entire amount should now be excluded from expenses.

Adjustments have been proposed to correct the "local only" adjustments made by the company and to adjust the company's rate base and capital structure. OPC supported an NOI increase of $808,939. Our Staff agreed with this adjustment, which would decrease intrastate expenses by $1,297,000. GTEFL opposed the adjustment to its NOI. We approve this adjustment.

The company's 1988 surveillance report includes an adjustment to increase rate base and to increase deferred taxes to show the deferred taxes on intercompany profits. The amount of the rate base adjustment was $7,550,000, which is the intrastate local portion of the adjustment. GTEFL said that a rate base adjustment of $5,187,000 should be made. OPC and our Staff believe that the correct amount of the adjustment should be $4,315,000 for a total intrastate adjustment of $11,856,000 including the company's adjustment of $7,550,000. We approve an adjustment to increase GTEFL's intrastate rate base by $4,315,000 and that GTEFL's actual adjustment on the surveillance report should excluded.

GTEFL and OPC have proposed recording equal adjustments to total company deferred taxes and to rate base. We believe that this would be incorrect since the deferred taxes are further adjusted to remove interstate amounts. This proposed adjustment would double count the interstate portion and understate the intrastate portion of deferred taxes. Our Staff recommended that intrastate deferred taxes should be increased by $11,865,000. We approve this adjustment.

10. <u>"Immaterial" Out-of-Period Adjustments</u>:

An item of $330,000 in intrastate expense, affecting GTEFL's NOI by $205,821, was not eliminated in the company's surveillance report as an out-of-period item because the company considered it immaterial. GTEFL and OPC do not oppose our Staff's recommendation that an adjustment be made to correct these out-of-period expenses. We approve this adjustment.

11. <u>Depreciation Adjustment</u>:

A portion of the work papers of our Staff's audit of GTEFL's books and records was introduced into evidence as an exhibit. This exhibit contains a reference indicating our Staff auditor was told that no "Blue-back points" were issued. "Blue back points" are memoranda on internal control structure issued to the company by its outside auditor. Contrary to this representation, there were "Blue-back points" issued, and one of these points concerned Central Office Equipment that should have been retired in 1987 but was not recorded until 1988. The effect of not making this adjustment was to overstate 1988 depreciation expense. Staff recommended in this instance that GTEFL's NOI be adjusted by $366,000, thereby decreasing intrastate expenses by $586,820, to remove the depreciation expense associated with Central Office Equipment retired in 1988, and OPC supported this adjustment. GTEFL took the position that no adjustment should be made to its 1988 depreciation expense. We approve this adjustment.

12. Inventory Adjustment:

Another of the "Blue back" points discussed above concerned an inventory of computer and data equipment in 1987 that shows a $7,000,000 "book-to-physical" adjustment that was not recorded until February 1988. 7This overstates the rate base and depreciation expense. Our Staff recommended that depreciation expense should be reduced by $94,597, which increases NOI by $59,000. Staff also recommended a rate base adjustment of $1,667,607 to reflect the inventory adjustment as of December 31, 1987, rather than when it was booked in 1988. OPC supports our Staff's recommendation. GTEFL believes that no adjustments should be made regarding the inventory of computer equipment. We approve these adjustments.

13. Directory Advertising Revenues:

In GTEFL's last rate case, all directory advertising revenues and expenses were considered "above-the-line" in the proceedings. Subsequently, the Legislature enacted Section 364.037, Florida Statutes, which directs us to allocate a portion of these revenues "below-the-line". OPC has argued in this proceeding that, since this is not a rate case, this statute should not apply. OPC maintains that GTEFL's NOI should be adjusted by $12,510,000 in order to reverse the adjustment made in GTEFL's 1988 surveillance report that excluded a portion of directory advertising revenues. GTEFL states that OPC's position is contrary to the statute which, along with our rules, should apply regardless of the treatment accorded these revenues during GTEFL's last rate case. We agree with Staff's belief that the legislative intent of Section 364.037 applies in all instances; therefore, we reject the adjustment proposed by OPC.

14. Rent Expense:

As explained above in our discussion of Quad Block Property and One Tampa City Center, OPC has recommended that an adjustment be made to the rent expenses recorded in 1988 by

GTEFL. The adjustment proposed by OPC is $3,268,000 which represents all rent expense associated with One Tampa City Center. OPC maintains that this adjustment is appropriate because the company has not met its burden of proving that this rent expense is reasonable.

We have discussed above the pending examination of the transactions dealing with the Quad Block property and One Tampa City Center that we directed our Staff auditors to undertake. No final conclusion has yet been reached by them as to the reasonableness of this rent expense. As mentioned above, we approve no adjustment at this time relating to these issues but reserve until the completion of our investigation of these matters. Based on the conclusions reached as a result of this investigation, we may take action later in this proceeding involving 1988 rent expense that could involve an additional disposition of GTEFL's 1988 tax savings.

15. <u>Gross Receipts Taxes</u>:

Gross Receipts Taxes relating to the interstate Customer Access Line Charge were improperly separated to the intrastate jurisdiction. Our Staff recommended that intrastate expenses be decreased by $861,163, which results in an increase in NOI of $537,107, in order to correct the allocation of Gross Receipts Taxes. OPC agreed with Staff's recommendation, and GTEFL agreed on the condition that the adjustment discussed below is approved. We approve this adjustment.

16. <u>Franchise Fees</u>:

The company provided an exhibit containing information about its Franchise Fees and other taxes. The company collects Franchise Fees on intrastate revenue only and records the Franchise Fees which it bills as intrastate revenue. When the company pays a Franchise Fee to a local municipality, it records the payment as an expense. The company incorrectly charged part of the Franchise Fees expense to the interstate jurisdiction. Our Staff recommends that GTEFL's NOI be decreased by $1,146,000, increasing intrastate expenses by $1,837,378, in order to correct this error. GTEFL agreed with this recommendation. OPC believes that no adjustment for Franchise Fees should be made; however, it incorporates this adjustment into a late-filed exhibit which it submitted. We approve this adjustment.

IV. 1988 REFUND

A. 1988 Tax Savings:

GTEFL believes that its total 1988 tax savings are $36,074,000. The company calculated this amount in two steps, by computing first the amount reflecting the effective tax change from 46% to 39.95% in 1987 and then determining the amount relating to the change from an effective rate of 39.95% to 34% in 1988. GTEFL also believes that $19,893,656 of its total 1988 tax savings has been disposed of through the on-going effects of reductions in access charges and eliminations of some zone charges. Moreover, GTEFL took the position that an additional $18,000,000 of 1988 tax savings was disposed of by a one-time 1987 depreciation adjustment. OPC believes the total amount of tax savings for 1988 is $41,631,000.

Our Staff disagreed with the calculations made by both parties and argued that the total 1988 tax savings are $40,935,000 prior to giving effect to its proposed earnings adjustments. Staff said that the total amount of tax savings for 1988 is $41,433,000, based on the reduction in the corporate income tax rate from 46% to 34% and using 1988 data. Our Staff recommended that we find that the total amount of these tax savings disposed of to date by the company is $19,894,000. In Staff's view, the net amount is $21,539,344.

After considering the arguments, we will accept Staff's proposed methodology for calculating the total amount of GTEFL's 1988 tax savings. However, in light of our approving above an adjustment for HSN litigation expense that was less than recommended by Staff, we cannot adopt the total amount of such tax savings calculated by Staff. We approve the total amount of $41,281,000 as GTEFL's 1988 tax savings. Our calculation takes into effect the total amount of the adjustments approved above.

B. 1987 Depreciation:

An issue was raised in this proceeding as to whether GTEFL's one-time intrastate depreciation expense adjustment of $18,000,000 recorded in December of 1987 pursuant to Order No. 18584, issued December 21, 1987, disposes of the company's 1988 tax savings. GTEFL argued that the company disposed of its 1988 tax savings through an access charge reduction and the elimination of zone charges pursuant to Order No. 17382 and by increasing its depreciation expense. Of these three items, the company acknowledges that the former two items continue to reduce its revenues every year with only the depreciation charge as a nonrecurring item. For 1988, the company estimates that its revenues were lowered $18,418,967 by the access charge reduction and $1,474,689 by the elimination of zone charges. GTEFL maintains that the $18,000,000 in increased depreciation expense should be included to result in the company returning to ratepayers a total amount of $37,893,656 as opposed to $36,074,000, which is its calculation of total tax savings. The company argued that this increase in its 1987 depreciation expense results in a disposal of tax savings to the benefit of its ratepayers.

OPC disagreed, asserting its belief that changes in depreciation expense are irrelevant under the Tax Rule. OPC contended that the Tax Rule calls for refunds if the company earns above its allowed return on equity, not depreciation adjustments. In addition, a depreciation adjustment made during 1987 is believed by OPC not to have a bearing on whether the company returned its 1988 tax savings to its customers. OPC notes that GTEFL made no depreciation adjustments during 1988.

Our Staff urged us to find that the 1987 one-time intrastate depreciation expense adjustment of $18,000,000 does not satisfy in whole or in part the requirements of the Tax Rule for 1988. A Staff witness testified that the order authorizing the $18 million additional expense for that year states that the company's petition for such relief shows good cause for our action. A company witness confirmed that this petition lists the following reasons for the request: (1) to eliminate reserve deficiences, (2) to avoid having to recognize the expense in future periods, (3) to recognize separations changes, and (4) to recognize implementation of the new USOA and the Florida sales tax changes. This witness further acknowledged that this petition failed to mention any 1988 tax savings impact. The Staff witness points out that, if the company had intended to record the additional expense in 1988 rather than 1987, it would have been made part of the normal depreciation represcription process which took place in 1988.

Further, the company witness agreed that in GTEFL's petition for rate stabilization, filed on January 28th, 1988, the schedules showing how the company's 1988 tax savings had been resolved contain no reference to the one-time 1987 depreciation adjustment. She cited the August 1988 letter as being the means by which we were notified of the company's decision to use the 1987 expense as an offset to tax savings. She agreed that we have never said, either at an Agenda Conference or in an order, that the 1987 depreciation expense amount adjustment would offset 1988 tax savings.

We accept our Staff's recommendation that GTEFL's one-time intrastate depreciation expense adjustment of $18,000,000 recorded in December of 1987 pursuant to Order No. 18584, issued December 21, 1987, does not dispose of any of GTEFL's 1988 revenues under the Tax Rule. We do not believe it appropriate to apply an expense incurred in a prior year as an offset to those revenues collected during a subsequent year which represent tax savings. When approving the company's request for this 1987 depreciation adjustment, we did not intend that it should be used to offset the 1988 tax savings.

C. 1987 Access Charge Reduction:

This issue concerns whether GTEFL's 1987 access and zone charge reductions satisfy the Tax Rule by disposing of the company's tax savings for 1988 and subsequent years. Our Staff recommended that we hold that these 1987 reductions do partly satisfy the Tax Rule for 1988 and should be considered as the disposition of $19,893,656 in 1988 tax savings. Staff's position is that GTEFL's CCL charge and zone charge reductions are permanent rate decreases that carry forward to subsequent years. Because of these ongoing effects, Staff believes that it is appropriate to consider these reductions as using up part of the tax savings in subsequent years. GTEFL agreed, maintaining that these 1987 reductions reduce the gross amount of tax savings available for disposal in 1988. In the company's view, our rules recognize that the Tax Rule becomes moot when permanent rate reductions are incurred.

OPC disagreed with Staff and the company, arguing that the Tax Rule calls for refunds of tax savings if the company earns above its midpoint ROE. This rule's use of the term "refund" does not contemplate the use of an access charge rate reduction as a "refund" because it further states that the utility may make any refund either as a lump sum payment in billing or in monthly installments not to exceed 12 months. It also states that such refunds are to be made to or from customers of the utility at the time that such refunds are effected. In OPC's opinion, neither access charge rate reductions for interexchange carriers nor zone charge rate reductions fit this description.

By Order No. 17053, we proposed a reduction of the Carrier Common Line (CCL) rate by the local exchange companies (LECs) in order to deload nontraffic sensitive costs from access charges. This order provided no specific mechanism for offsetting revenues lost through lower access charges, stating that the LECs would be dealt with on a case-by-case basis in determining whether any additional revenue is needed and the appropriate source and level. GTEFL requested a hearing as a result of this Proposed Agency Action. Order No. 17382, issued April 8, 1987, approved a settlement proposed by GTEFL and our Staff and ordered the reduction of GTEFL's CCL rate to be effective May 1, 1987. It also required a reduction in certain local rates by eliminating or reducing zone charges. Order No. 17382 stated that the permanent rate reductions were in lieu of our application of the Tax Rule.

Nevertheless, OPC argued that Order No. 17382 says nothing about permanently offsetting GTEFL's obligation under the Tax Rule on account of the access charge rate reduction effected by GTEFL in 1987. While this order does not explicitly state that these reductions permanently offset GTEFL's obligation under the Tax Rule, we note that OPC did not protest this order which stated that the CCL reductions was accepted in lieu of applying the Tax Rule in 1987.

In our opinion, it would be unreasonable not to consider the permanent rate reductions as permanent offsets to the Tax Rule. We agree with Staff and the company that these access and zone charge reductions have on-going effects, and we find that they are appropriate offsets to tax savings in future years. For the reasons stated above, we hold that GTEFL's 1987 CCL and zone charge reductions partly satisfy the Tax Rule in 1988 and subsequent years. GTEFL's 1988 revenues were reduced by $18,418,967 through the CCL charge reduction and by $1,474,689 through the zone charge reduction.

D. Other Revenues Increases & Decreases:

OPC raised the issue of whether other increases or decreases in GTEFL revenues, such as those resulting from stimulation, late payment charges, new services, local exchange regroupings, EAS or tariff filings, should be considered in determining whether the Tax Rule has been satisfied for 1988 and subsequent years. OPC argued that these numerous rate increases are no less relevant than are the CCL and zone charge decreases. If the access and zone charge decreases are allowed to offset tax savings, OPC believes that we should consider those rate changes which increased the company's revenues. OPC claimed that the total new service revenues for the period of 1986-1988 of $24,531,554 should be reduced by the amount of earnings received when these services were first introduced in 1986, $9,986,264. The difference between these two amounts, $14,573,995, reflects new service revenues and rate increases for 1988 received by GTEFL, and OPC sought to have this net revenue increase used to offset the rate reductions. However, OPC continued to assert that the Tax Rule does not apply to any of these rate changes. As pointed out above, OPC argued that the use of the term "refund" in the Tax Rule does not contemplate the use of access charge or zone charge rate reductions as "refunds."

GTEFL believes that there is a difference between the permanent rate reductions experienced in 1987 and any revenues associated with new services first introduced in 1988. As also pointed out above, GTEFL argued that the Tax Rule is designed to return tax savings based on the revenues and expenses of the company in effect at the time the permanent rate reductions are incurred. Once this is accomplished, GTE said that the Tax Rule becomes moot. GTEFL claimed that once its rates are reduced, an equal level of tax savings are eliminated. A future rate increase may increase the earnings of the company, according to the company, but such matters are unrelated to tax savings.

Our Staff urged us not to consider increases or decreases of GTEFL revenues, such as those discussed in this issue, in determining whether the Tax Rule has been satisfied in 1988 and subsequent years. In Staff's view, increases or decreases in GTEFL's revenues should be considered as part of the earnings test contemplated by the Tax Rule and should not be taken into consideration when determining the disposition of 1988 tax savings.

As mentioned above, Order No. 17382 accepted GTEFL's CCL and zone charge reductions in lieu of our applying the Tax Rule. By not protesting this Proposed Agency Action, OPC must be assumed to have agreed to this action as disposing of 1987 tax savings. Because GTEFL's CCL and zone charge reductions are permanent, we have found above that they are appropriate offsets to the Tax Rule. In our orders approving revenue increases resulting from new service offerings, we have not declared them to be items compelling consideration under the Tax Rule. Our goals in reducing GTEFL's CCL and zone charges were to deload the nontraffic sensitive costs and to satisfy the Tax Rule. In the case of some telephone companies, the CCL reduction disposed of all tax savings, satisfying in whole the Tax Rule, and we required no additional rate reductions. To require that revenue increases offset these rate reductions would not be appropriate absent a finding that such action would be considered as affecting tax savings.

We reject OPC's position that these revenue increases should be used to offset the CCL and zone charge reductions in determining the disposition of GTEFL's 1988 tax savings. However, these revenue increases from new services do raise the levels of the company's earnings and tax savings. While the access and zone charge reductions will have a negative impact on the company's achieved earnings, the increased revenue from new services will increase its achieved earnings. For these reasons, we will adopt our Staff's recommendation that increases or decreases of GTEFL revenues, apart from those designated as disposing of tax savings, not be considered in determining whether the Tax Rule has been satisfied in 1988 and subsequent years.

E. Double Liability:

GTEFL argued that the application of a new ROE or a new capital structure exposes the company to double liability in this circumstance where GTEFL returned all of its 1988 tax savings and still earned above its midpoint ROE during 1988. In reliance on prior Commission actions, GTEFL said it returned to its ratepayers all of the tax savings associated with the Act through a combination of access charge reductions, elimination of zone charges and increased depreciation expense. GTEFL said it took this action in order to return tax savings up front and to utilize the tax savings in a manner which was beneficial to its ratepayers. GTEFL asserted its position that refunding tax savings constitutes imprudent regulation. If we apply the Tax Rule with a ROE which reduces the refund threshold, the company complained that it will be faced with double liability for 1988. The application of a lower ROE for calculations under the Tax Rule will place GTEFL in a position where it has returned tax monies twice to its ratepayers, according to the company.

OPC and our Staff disagreed with GTEFL. OPC believes that the company has not returned tax savings to its customers during 1988. In addition, OPC contended that the company has consented to, and we have asserted, jurisdiction to use a January 1, 1988 effective date for any resolution of this docket. There is no "double liability" to GTEFL, in OPC's opinion. Staff's opinion is that only a partial disposition of all 1988 tax savings has been accomplished and that the remaining tax savings should be disposed of in accordance with the Tax Rule. The application of this rule using a new ROE and a new capital structure does not constitute "double liability", in Staff's view, because it does not recommend disposition of revenues in excess of total 1988 tax savings.

Upon review of the arguments, we hold that the application of a new ROE or a new capital structure does not expose GTEFL to double liability because GTEFL has not returned all 1988 tax savings. We do not intend to force GTEFL to return tax savings twice for any year. The largest amount of tax savings any company should be compelled to return is the entire amount of tax savings for that year. In adopting the Tax Rule, we chose to limit the refund amount to those savings that cause a company's earnings to exceed the level at which rates were set. GTEFL is to be commended for its goal of returning all tax savings regardless of earnings. It is possible that GTEFL could be subject to double liability if disposition had been made of all tax savings for 1988; however, we do not believe that all 1988 tax savings have been disposed of.

F. Refund Amount:

GTEFL asserted that it has no liability in this case because its 1988 tax savings have already been disposed of for the ratepayers' benefit independent of the Tax Rule. In addition, the company alleged that a proper application of the Tax Rule produces no refund amount. OPC maintained that the full amount of the tax savings should be refunded, with interest, to the extent that GTEFL's earnings, properly calculated and using the consolidated capital structure of the GTE companies, exceeded an ROE of 12.75%.

In promulgating the Tax Rule, we approved a limitation on the tax savings to be refunded based on the midpoint of the utility's ROE; however, the record makes clear that GTEFL's goal is to dispose of 100% of its tax savings irrespective of its earnings level. The company believes that it has returned all of its 1988 tax savings; however, we disagree with this conclusion. We are not adverse to adopting a refund alternative when it presents a clear benefit to the ratepayers, but in this circumstance, we believe that a refund is the appropriate method of satisfying the company's goal, benefitting the ratepayers and resolving the question of 1988 tax savings.

We found above that GTEFL's 1988 tax savings are $41,281,000 of which $19,894,000 has been disposed of, leaving $21,387,000 in 1988 tax savings for disposition. We conclude that $21,387,000 of tax savings plus interest of $3,258,000 should be refunded. This interest amount was calculated under the assumption that the refund will be completed in the February 1990 billing cycle. Refunds shall be made to customers of record as of December 31, 1988, and shall be credited to business and residential customers in the same proportion as the various local exchange rates bear to each other.

G. Capital Structure:

Three witnesses presented testimony on the appropriate capital structure that should be used to determine the actual ROE earned by GTEFL in 1988. They addressed two areas of contention. The first contention dealt with whether we should use GTEFL's actual capital structure to determine the return on common equity earned by the company during 1988. OPC's witness proposed that we adopt the consolidated capital structure of the GTE companies to determine the overall cost of capital for GTEFL. The consolidated capital structure at the end of 1988 had a common equity ratio of 43.6%. The company witness disputed the use of this consolidated capital structure for determining GTEFL's overall cost of capital. He recommended that GTEFL's actual capital structure, as shown in the company's surveillance report dated December 31, 1988, should be used. GTEFL's capital structure reported there shows an equity ratio of 56% of investor sources of capital.

The second area of contention addressed is the manner in which GTEFL's non-regulated investments should be removed from its capital structure. The Staff witness proposed that we adopt GTEFL's actual capital structure; however, he recommended adjusting it to remove non-regulated investments directly from common equity. Removing non-regulated investments directly from common equity produces an equity ratio of 54.35% of investor sources of capital. The GTEFL witness argued that the prorata removal of non-regulated investments as shown in the December 1988 surveillance report is appropriate.

Staff's witness testified that bond rating agencies have acknowledged that business risk in the telecommunications industry has increased since the divestiture by AT&T of the Bell Operating Companies. In 1985, he said Standard and Poor (S&P) recognized this higher risk in the telecommunications industry by changing its financial benchmarks to reflect higher pretax interest coverage and lower total debt to total capital ratios. S&P's debt ratio benchmark is under 42% for local exchange companies rated "AA". Currently, GTEFL is rated "AA-" by S&P and "Aa2" by Moody's, and the company's objective is to maintain its current bond ratings. We believe this objective to be reasonable.

S&P classifies the business risk of LECs as either "high" or "low," and GTEFL falls within the "high" risk category. Currently, GTEFL's equity ratio compares favorably, although slightly lower, to a peer group of telecommunication companies categorized as "high" risk. In our opinion, GTEFL's capital structure appears reasonable. We accept the testimony of the Staff witness that GTEFL's actual capital structure should be used in determining GTEFL's 1988 ROE. Our reliance on its actual capital structure for ratemaking purposes should allow the company to recover the financing costs associated with providing telephone service.

In our opinion, the use of a hypothetical capital structure, when the company's actual capital structure appears reasonable, could negatively affect the company's ability to meet investor requirements. Additionally, imputing a different capital structure in such a circumstance may force a company to move towards a less efficient capital structure, thereby reducing its ability to react to changes in its operating environment. This could result in the company's debt being downgraded. If GTEFL were to reduce its equity ratio down to the level of 43.6% recommended by OPC's witness, GTEFL's debt would most likely be downgraded. For S&P's high-risk telecommunications companies, an equity ratio of 43.6% falls within the "BBB" rating category.

OPC's witness implied that cash flows, and not business risk, should determine the equity ratio used for regulatory purposes. He appeared to subscribe to the theory of using the capital structure as a method of managing cash flows. The proposal to manage cash flow through the utility's capital structure is contrary to generally accepted financial theory and would send the wrong signals to investors and ratepayers. For these reasons, we reject OPC's request that we use the consolidated capital structure of the GTE companies instead of GTEFL's actual capital structure.

We agree further with Staff's witness that non-regulated investments should be removed directly from equity. In our opinion, utilities are of relatively low risk and have correspondingly lower costs of capital. There are very few investments a utility can make that are of lower or equal risk. As a result, non-regulated investments will almost certainly increase a utility's cost of capital. The company's witness indicated that GTEFL's non-regulated investments are riskier but argued that, even though there is a higher cost of capital associated with higher risk investments, the prorata removal of GTEFL's unregulated investment is appropriate. This argument contradicts generally accepted financial theory and accordingly is rejected. We conclude that removing non-regulated investments directly from equity recognizes their higher risks, prevents cost of capital cross-subsidies, and sends a clear signal to utilities that ratepayers will not subsidize non-utility related costs.

For purposes of computing the company's 1988 earnings, we adopt GTEFL's actual capital structure as reflected in its December 1988 surveillance report adjusted to remove non-regulated investments directly from equity and adjusted for deferred taxes for intercompany profits. We approve equity ratios of 54.35% of investor sources of capital and 43.81% of all sources of capital.

V. <u>1989 ROE</u>

Following the submission of all witnesses' prefiled testimony, the parties agreed to add an issue to consider the appropriate ROE midpoint to be used in applying the Tax Rule to GTEFL's 1989 earnings. Each party revised its prehearing statement to take a position on this issue, and these positions are summarized below.

The company believes that its authorized midpoint of 15.5% should be used 1989 if the Tax Rule is to be applied to its 1989 earnings. OPC said that, if we use the consolidated capital structure for the GTE companies, the midpoint of the ROE range for GTEFL should be set at 12.75%. Further, OPC urged that, if we use the GTEFL capital structure rather than the proposed capital structure, the midpoint of the ROE range should be set at 11.75%. Our Staff initially took the position that 11.50% should be used as the ROE midpoint for purposes of applying the Tax Rule to GTEFL for 1989.

None of the witnesses addressed at hearing the return on equity required by investors at the beginning of 1989. At the Agenda Conference held on December 11, 1989, our Staff recommended that we set a midpoint ROE of 12.9% for the purpose of applying the Tax Rule in 1988. For all regulatory purposes on a prospective basis, Staff recommended a range with a minimum of 10.7%, a midpoint of 11.7%, and a maximum of 12.7%. However, Staff did not believe that the 11.7% midpoint ROE recommended for prospective application represents the midpoint that should be used for purposes of the Tax Rule for GTEFL in 1989. Instead, Staff recommended that we set 12.9% as the midpoint in applying the Tax Rule to GTEFL's 1989 earnings.

The prospective 11.7% midpoint ROE recommended by Staff represents a market-based rate which reflects all the information available as of the hearing date. In Staff's opinion, the manner in which the midpoint for Tax Rule application in 1989 should be determined is to look at investor return requirements at the beginning of 1989, which is the approach used by the Staff witness to determine the midpoint for tax rule purposes for 1988.

Based on the movement of interest rates between January 1988 and January 1989, Staff does not believe that the cost of equity for GTEFL at the beginning of 1989 was any higher than the 12.9% recommended for 1988. A schedule supporting Staff witness's testimony indicates that the midpoints of GTEFL's cost of common equity from the second quarter of 1987 through a current estimate for 1989. The cost of equity was slightly lower but did not decline significantly from the first quarter of 1988 to the first quarter of 1989.

We cannot adopt our Staff's recommendation on this issue because, in our opinion, a higher ROE is more reasonable. Accordingly, we establish a 13.2% ROE midpoint for purposes of applying the Tax Rule to GTEFL's 1989 earnings.

VI. PROSPECTIVE ROE

A. Equity Ratio:

In order to determine the ROE to authorize for GTEFL on a prospective basis, we have considered the appropriate equity ratio that should be used. GTEFL believes that the evidence of record and the controlling legal principles clearly support the use of the company's own capital structure for application to the issues in this proceeding. OPC proposed the consolidated capital structure of the GTE companies, consisting of 43.22% common equity, as appropriate for determining the regulated earned ROE for GTEFL. Our Staff's witness testified that the company's actual capital structure should be adjusted to reflect all regulatory adjustments, including the removal of non-utility or non-regulated assets from equity.

For the reasons discussed above in connection with our holding on the issue of the proper capital structure to use in determining the company's ROE earned in 1988, we find that GTEFL's actual capital structure, with one exception, should be used in establishing a prospective ROE. The exception deals with removing nonregulated investments directly from equity. As explained above, in its surveillance report, GTEFL removed its non-regulated investments by prorating it over all sources of capital. We adopt our Staff's recommendation that nonregulated investments should be removed directly from common equity instead of prorating their removal. This adjustment provides an equity ratio of 54.35% of investor sources of capital and reflects a ratio of 43.81% of all sources of capital.

B. ROE RANGE:

A wide range of minimum, midpoint and maximum ROEs were proposed by the parties for us to authorize for GTEFL on a prospective basis to be used for all regulatory purposes. The

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company proposed the following spread of ROEs as appropriate: 13.4% to 14.0% as the minimum; 14.4% to 15.0% as the midpoint; and 15.4% to 16.0% as the maximum. OPC suggested alternative ROEs. If we use the consolidated capital structure for the GTE companies, the minimum, midpoint and maximum ROEs should be set at 11.75%, 12.75% and 13.75, respectively. But if we use GTEFL's capital structure, the minimum, midpoint and maximum ROEs should be set at 10.75%, 11.75%, and 12.75%, respectively. Staff's witness testified that ROEs of 10.50%, 11.50%, and 12.50% should be set as the minimum, midpoint, and maximum, respectively.

We cannot adopt any of the parties' recommendations on this issue because, in our opinion, higher ROEs than proposed by OPC and our Staff and lower ROEs than proposed by the company are more reasonable. Accordingly, we establish for GTEFL a 12.3% ROE midpoint for all prospective regulatory purposes. Our general practice in recent years has been to establish a 100 basis point range above and below the midpoint ROE that we set. We will follow this practice in this case and establish an authorized minimum of 11.3% and an authorized maximum of 13.3%.

VIII. <u>ORDERING PARAGRAPHS</u>

It is therefore,

ORDERED by the Florida Public Service Commission that each and all of the specific findings herein are approved in every respect. It is further

ORDERED that GTE Florida Incorporated and the Office of the Public Counsel shall submit Briefs as directed herein. It is further

ORDERED that GTE Florida Incorporated shall make the refund specified herein. It is further

ORDERED that the midpoint of the return on equity established in the body of this Order shall be used in applying Rule 25-14.003, Florida Administrative Code, to GTE Florida Incorporated's earnings in 1989. It is further

ORDERED that the minimum, midpoint and maximum returns on equity established in the body of this Order for prospective

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application shall be used for all regulatory purposes. It is further

ORDERED that these dockets shall remain open for further proceedings.

By ORDER of the Florida Public Service Commission, this 29th day of December, 1989.

Steve Tribble
STEVE TRIBBLE, Director
Division of Records and Reporting

(S E A L)

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Commissioner Herndon dissented as to the establishment of a 13.2% midpoint return on equity for applying Rule 25-14.003, Florida Administrative Code, to the 1989 earnings of GTE Florida Incorporated.

Chairman Wilson and Commissioner Gunter dissented as to the establishment for GTE Florida Incorporated of returns on equity of 11.3%, 12.3% and 13.3% as the minimum, midpoint and maximum for all regulatory purposes on a prospective basis.

NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.59(4), Florida Statutes, to notify parties of any administrative hearing or judicial review of Commission orders that is available under Sections 120.57 or 120.68, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing or judicial review will be granted or result in the relief sought.

Any party adversely affected by the Commission's final action in this matter may request: 1) reconsideration of the

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decision by filing a motion for reconsideration with the Director, Division of Records and Reporting within fifteen (15) days of the issuance of this order in the form prescribed by Rule 25-22.060, Florida Administrative Code; or 2) judicial review by the Florida Supreme Court in the case of an electric, gas or telephone utility or the First District Court of Appeal in the case of a water or sewer utility by filing a notice of appeal with the Director, Division of Records and Reporting and filing a copy of the notice of appeal and the filing fee with the appropriate court. This filing must be completed within thirty (30) days after the issuance of this order, pursuant to Rule 9.110, Florida Rules of Appellate Procedure. The notice of appeal must be in the form specified in Rule 9.900(a), Florida Rules of Appellate Procedure.