IN THE SUPREME COURT OF FLORIDA

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JUN 18 1985
CLERK, SUPREME COURT
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UNITED TELEPHONE COMPANY
OF FLORIDA,

Appellant,

vs.

JOHN R. MARKS, III, et al.,

Appellee.

CASE NO. 66,673

(CONSOLIDATED CASES)

GENERAL TELEPHONE COMPANY
OF FLORIDA,

Appellant,

vs.

JOHN R. MARKS, III, et al.,

Appellee.

CASE NO. 66,633

ON APPEAL FROM THE FLORIDA PUBLIC SERVICE COMMISSION

# ANSWER BRIEF OF SOUTHERN BELL TELEPHONE AND TELEGRAPH COMPANY

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## STATEMENT OF THE CASE AND THE FACTS

Appellee, Southern Bell Telephone and Telegraph Company ("Southern Bell"), submits that the statement of the case and facts in the briefs of appellants, United Telephone Company of Florida ("United"), and General Telephone Company of Florida ("General"), should be supplemented.

In May, 1983, the Florida Public Service Commission (the "Commission") directed Southern Bell to submit reports on the effect of the American Telephone and Telegraph Company ("AT&T") divestiture on its operations and financial structure. In February, 1984, Southern Bell petitioned for an increase in rates and charges. One reason for the increase it requested was that it had suffered a revenue shortfall on account of both deregulation and its transfer to AT&T of consumer premises equipment ("CPE"). This was required by the divestiture decree and by later orders of the Federal Communications Commission ("FCC"). See United States v. American Telephone & Telegraph Company, 552 F.Supp. 131 (D. D.C. 1982), aff'd sub nom., Maryland v. United States, 460 U.S. 1001 (1983). The Commission treated Southern Bell's filing as a petition to determine the cost of divestiture, not as a rate case. Order No. 14047 (the "Order") at 2 (Jan. 30, 1985) (R. 537). The Commission has broad

authority to conduct such proceedings. §§ 364.055, 364.14, Fla.Stat. (1983).

As part of the AT&T divestiture, Judge Greene required all Bell operating companies (the local Bell telephone companies), including Southern Bell, to transfer all CPE to AT&T effective January 1, 1984. In addition, the FCC has required all telephone companies to phase out, over a five-year period, their use of CPE expenses in setting long distance rates. The Commission has also approved this phase-out. Beginning January 1, 1983, and continuing until December 31, 1988, one-sixtieth of CPE related expenses are being removed each month. Testimony of Menard (R. 576-78).

Intrastate long distance rates are set on a statewide basis, and the resulting revenues are "pooled". Order at 15 (R. 551). Even though intrastate long distance rates are approved by the Commission, the revenues in the pool are divided as provided in private contractual settlement agreements between the Florida telephone companies.[1]

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1. Only recently has the Commission been granted direct statutory authority to regulate such agreements. §364.07, Fla.Stat. (1983).

Most of the settlement agreements between Florida telephone companies were substantially revised effective January 1, 1984. The agreements between Southern Bell and both United and General were among those revised at that time. Order at 15-16 (R. 551-52).

United's revised agreement with Southern Bell included a provision stating:

> From time to time, the FPSC, after due process, may issue orders relating to generic matters that direct all or certain Florida telephone companies to make changes that affect IntraLATA/Intramarket investment, revenue, expense or tax items.

General's revised agreement with Southern Bell included a provision stating:

> In addition, the FPSC may issue orders that direct certain telephone companies to adjust intrastate interLATA/intermarket investment, revenue, expense or tax items in settlements.

The agreements generally provide that the pool of revenues will be divided according to each telephone company's expenses. This means that the larger a telephone company's expenses, the larger the telephone company's draw from the pool.

After Southern Bell's transfer of CPE to AT&T on January 1, 1984, the pool of intrastate long distance revenues continued to include additional revenues resulting from the imputation of Southern Bell's CPE related expenses. These expenses were included at the time intrastate long distance rates were approved by the

Commission. For 1984 alone, the amount of the pool was approximately $19.8 million larger because of Southern Bell's CPE expenses. Order at 15 (R. 551). It was open to question, whether Southern Bell's share of the pooled revenue should be reduced, since it had divested itself of the CPE. If Southern Bell were not permitted to continue to recognize its CPE related expenses, the other Florida telephone companies, including United and General, would benefit. The other telephone companies would be entitled to draw their share of the additional residual revenues in the pool resulting from inclusion of Southern Bell's CPE expenses in setting long distance rates. This windfall benefit to other Florida companies would have totalled $9.7 million. Order at 16 (R. 552).

Most importantly, if the Commission had permitted United and General to retain this windfall, Southern Bell would be entitled to a local rate increase due to the resulting revenue short fall. Id. The net effect would have been to transfer wealth from Southern Bell's ratepayers to other telephone companies. The Commission "did not believe . . . that the intent of divestiture was to create a windfall for the LECS [other Florida telephone companies] at the expense of Southern Bell's ratepayers." Id.

Accordingly, in Order No. 14047 the Commission authorized Southern Bell to continue to recognize CPE expenses and remove the $9.7 million ratepayers had contributed to the settlements pool. This appeal by United and General followed.

## SUMMARY OF ARGUMENT

The Commission has broad authority to hold hearings and enter appropriate orders on the effects of divestiture. Under the toll settlement contracts between Southern Bell and the other Florida telephone companies, including United and General, the Commission may determine the proper expenses permitted to be used by each company in drawing from the settlements pool. The Commission allowed Southern Bell to continue to recognize CPE expenses in order to avoid a $9.7 million windfall to other Florida telephone companies, which would have been paid for by Southern Bell's ratepayers.

CPE expenses are not economically related to the cost any telephone company incurs in providing long distance service. Nevertheless, the Commission, for a transitional or phase-out period, has allowed all Florida telephone companies to continue to recognize part of their CPE expenses as proper expenses. The Commission's action in allowing Southern Bell to continue to recognize CPE expenses as proper expenses during a transitional period following divestiture must be viewed in the same light. The Commission has the authority to take such action in order to avoid a windfall and an increase in local rates to Southern Bell's customers.

The Commission's action was not retroactive ratemaking because the Commission simply allowed Southern Bell to continue to recognize CPE expenses. The Commission did not adjust revenues or modify the toll settlement contracts. Rates were not changed in any way by the Commission's Order.

I. THE COMMISSION ACTED PROPERLY IN CONTINUING TO RECOGNIZE SOUTHERN BELL CPE EXPENSES.

According to General's brief, the issue of "whether the Commission's action was proper rests solely on the language of the contracts and the evidence of record." General's Brief at 16. United takes a novel approach arguing "that a breach of the contracts has occurred as a direct consequence of the Commission's orders." United's Brief at 6.

Neither General nor United challenge the Commission's authority under §§ 364.055, 364.14, Fla.Stat. (1983)[2] to hold hearings and enter appropriate orders on the effects of divestiture. This statutory authority grants the Commission considerable discretion in determining the proper practices of Florida telephone companies. City of Miami v. Florida Public Service Commission, 208 So.2d 249,

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2. Section 364.055 of the Florida Statutes authorizes the Commission to grant interim rate relief, while section 364.14 authorizes the Commission to correct unjust or unreasonable telephone company practices. § 364.14(2), Fla.Stat. (1983) provides:

> Whenever the commission finds that the rules, regulations, or practices of any telephone company are unjust or unreasonable, or that the equipment facilities, or service of any telephone company are inadequate, inefficient, improper, or insufficient, the commission shall determine the just, reasonable, proper, adequate, and efficient rules, regulations, practices, equipment, facilities, and service to be thereafter installed, observed, and used and shall fix the same by order or rule as hereinafter provided.

(Emphasis added).

253 (Fla. 1968). Whether an expense is proper is clearly a discretionary matter. Id. at 260-61; General Telephone Company of Florida v. Florida Public Service Commission, 446 So.2d 1063, 1067 (Fla. 1984).

In addition, the plain language of Southern Bell's settlements contracts with General and United recognizes that the Commission has the authority to "issue orders that direct certain telephone companies to adjust intrastate interLATA/intermarket investment, revenue, expense or tax items in settlements" and may "issue orders relating to generic matters that direct all or certain Florida telephone companies to make changes that affect Intra LATA/Intra-Market investment, revenue, expense or tax items." The rights of the parties under the settlements agreements are made subject to Commission orders adjusting expenses.

On appeal, General argues, based upon the testimony of its witness, Ms. Menard, that Southern Bell's CPE expense is a "phantom expense", not like a depreciation expense, which she admitted could be adjusted by the Commission. General's Brief at 18. Similarly, United argues that the Commission's Order allows for a variance in the rates of return among the telephone companies and that such a variance could not occur if only expenses were changed.

United's Brief at 11.[3]

Both United and General have overlooked the basis of the Commission's Order. The Commission stated:

> As discussed above, the settlement agreements themselves contain provisions which recognize that the Commission may, from time to time, issue orders which have a direct impact on the revenues distributed through the settlements process. An obvious example of such orders would be the represcription of depreciation. If the Commission sets new depreciation rates for an individual company or multiple companies participating in a pooling arrangement, it will have a direct effect on the companies' allowable expenses for pooling purposes. That effect will ultimately carry over to the determination of the rate of return and revenues accruing to individual companies. The Commission has, in this case, recognized that, at least on an interim basis, Southern Bell has experienced a shortfall in CPE expenses which, but for divestiture, would have been recovered from the intrastate settlement pools. We find that it is entirely within the Commission's power to order the continued recognition of that expense for settlement purposes and to authorize Southern Bell to withdraw $9.7 million from the pools.

Order at 16. The Commission held it may order "the continued recognition of that [the CPE] expense for settlement purposes." Id.

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3. Both General and United have argued persuasively that the Commission did not rely upon § 364.07, Fla. Stat. (1983) in eliminating their potential windfall. The Commission and Southern Bell both agree with that position.

For more than two years the FCC, with the approval of the Commission, has recognized that CPE expenses are economically unrelated to the cost of providing long distance service. In a sense, they are "phantom" expenses to the extent they relate to long distance rates. For this reason they have determined that it is not appropriate for any telephone company to include CPE expenses in its long distance rate base. However, they have recognized the transitional problems that would be created if these expenses were suddenly eliminated. Because of these problems, the FCC chose to require CPE expenses to be phased out over a five-year or a sixty month period. If it had not been for the AT&T divestiture, Southern Bell would have equally participated in this phase-out along with General and United.

The important point is that United and General are currently including approximately one-half of their CPE expenses in their rate bases only because they are permitted to do so under the FCC's phase-out order. The order allowing telephone companies to retain part of their CPE expense during the phase-out creates a "phantom expense" just as surely as the Commission's order allowing Southern Bell to continue to recognize CPE expenses.

General and United have neglected to point out that the sole reason they have been allowed to charge CPE

expenses is to provide a smooth phase-out or transition. Virtually everyone in the telephone industry recognizes that CPE expenses are not economic expenses for long distance rate setting purposes, and in that sense the expenses are "phantom" for all telephone companies. Indeed, Ms. Menard, General's witness, presented the strongest testimony (R. 578-79) on this issue, stating:

> Q. Will you please explain the reasoning behind the removal of CPE from toll settlements?
>
> A. Yes. As I stated previously, a large portion of CPE investment and expense has been recovered through toll rates and distributed to LECs through toll settlements. These revenues have been used to offset local service costs, thereby allowing local service rates to be maintained at levels below actual cost. This subsidization process was sustainable because of the monopolistic nature of telephone service provision. The introduction of competition, and competitive pricing, in telecommunications necessitates that this subsidization end and prices more accurately reflect costs. It is recognition of this fact that has led to the removal of CPE from toll settlements.
>
> Q. What is the appropriate means of recovering these revenues as they are eliminated from the access charge and toll settlements pools?
>
> A. It is most appropriate to recover the resulting shortfall through local rates. It is local costs that these toll revenues have been subsidizing, so as the subsidy is removed, local rates should recover these local costs. To attempt to recover these revenues from any other source frustrates the intention, and denies the logic, of moving towards cost-based prices.

The arguments in the briefs submitted by General and United are premised upon their assumption that continued recognition of Southern Bell's CPE expenses are not proper expenses. For example, United claims that Southern Bell will receive a higher than permissible rate of return if Southern Bell is allowed to draw the $9.7 million from the revenue pool. Southern Bell's witness also testified that, based on the Commission's interim order, a higher rate of return resulted from allowing the withdrawal. In the interim order, the Commission had not yet decided whether to allow Southern Bell to continue to assign CPE expenses to the pool. If in fact, the CPE expenses were not properly assigned, a higher rate of return results from allowing Southern Bell to draw the $9.7 million. If they are proper expenses, Southern Bell does not receive a higher rate of return because of the expenses. In its final Order, the Commission determined that the CPE expenses were proper.

Southern Bell submits that if the Commission has the authority to allow General, United and other Florida telephone companies to continue using a portion of CPE expenses in determining intrastate settlements for transitional purposes, it certainly has the authority to allow Southern Bell to continue to recognize CPE expenses in order to avoid a windfall to other telephone companies

during the transitional period following divestiture. As the Commission stated:

> The Commission's action does not represent, as United and General suggest, a modification of the contracts between them and Southern Bell. On the contrary, we find that the position advocated by General and United would bind the hands of the Commission to exercise its regulatory duties and would ultimately result in a windfall to these companies. That windfall would ultimately have to be made up by Southern Bell from other sources, presumably from its Florida ratepayers.

The "orders of the Commission come before this Court clothed with the statutory presumption that they have been made within the Commission's jurisdiction and powers, and that they are reasonable and just and such as ought to have been made." General Telephone Company of Florida v. Carter, 115 So.2d 554, 556 (Fla. 1959); see Citizens of the State of Florida v. Public Service Commission, 448 So.2d 1024, 1026 (Fla. 1984). United and General can overcome this presumption only when the Commission's error plainly appears on the face of the order or where the error is made to appear by clear and satisfactory evidence. General Telephone, 115 So.2d at 557. This Court will not substitute its judgment for that of the Commission on a discretionary matter. General Telephone Company of Florida v. Florida Public Service Commission, 446 So.2d 1063 (Fla. 1984). General and United have not met this heavy burden.

Under the circumstances, the Commission acted properly in allowing Southern Bell to continue to recognize CPE expenses in order to avoid a windfall to United and General that would have been paid for by an increase in local rates charged to Southern Bell's ratepayers.

II. THE COMMISSION'S CONTINUED RECOGNITION OF SOUTHERN BELL CPE EXPENSES DOES NOT CONSTITUTE RETROACTIVE RATEMAKING.

In Southern Bell Telephone and Telegraph Company v. Florida Public Service Commission, 453 So.2d 780 (Fla. 1984), this Court found that the Commission has power to modify intrastate settlements contracts between telephone companies in the public interest. However, this Court, has held that the Commission may not do so on a retroactive basis stating:

> We simply hold that the Commission properly has the power to adjudicate the dispute, but may not retroactively adjust the distribution of revenues made pursuant to the telephone companies' arrangement prior to the Commission's order.

Id. at 784. (emphasis added).

The Commission did not act under § 364.07, Fla.Stat. (1984), nor did the Commission "adjust the distribution of revenues made pursuant to the telephone companies' arrangement prior to the Commission's order." The Commission simply allowed Southern Bell to continue to recognize CPE as an expense. The Commission did not adjust revenues or modify the toll settlement contracts. No retroactive change took place under the Commission's Order.

Furthermore, this Court in Citizens of the State of Florida v. Florida Public Service Commission, 415 So.2d 1268 (Fla. 1982), held that the Commission's grant of an

increase in equipment depreciation represcription to a telephone company did not constitute retroactive ratemaking. This Court found that to be the case even though the Commission's action had an incidental effect on the rate of return the telephone company was earning and the rates charged to ratepayers in the form of refunds owing. Id. at 1269-70. In this case, the Commission certainly had the authority to allow a continuation of an expense that had absolutely no effect on rates.

## CONCLUSION

The Court should affirm the Order of the Commission.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing has been furnished to JERRY M. JOHNS, General Counsel, United Telephone Company of Florida, Post Office Box 5000, Altamonte Springs, Florida 32715-5000; JAMES W. CARIDEO, Post Office Box 110 MC 7, Tampa, Florida 33602; and SID J. WHITE, 101 East Gaines Street, Tallahassee, Florida 32301, by U.S. Mail this 17 day of June, 1985.

Attorney

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