

TABLE OF CONTENTS

Page(s)

Table of Citations.....ii

The Public Service Commission designed its tax rule to ignore both rate increases and rate decreases.....1

The rate reduction to long distance carriers was not designed to pass through tax savings to customers, nor was it implemented in response to a petition filed by the Public Counsel.....5

Adherence to the Commission's tax rule using a midpoint return on equity of 13.5% provides United a fair rate of return.....11

Conclusion..... .13

TABLE OF CITATIONS

Cases

In re: Intrastate Telephone Access Charges for Toll Use of
Local Exchange Services, 87 F.P.S.C. 1:79 (1987).....6,7,9

In re: Petition by United Telephone Company of Florida for
Approval of a Return on Equity to be Used in 1988 for Purposes
of Rule 25-14.003, F.A.C., et. al., 88 F.P.S.C. 7:284
(1988)..... 9,10,13

In re: Intrastate Telephone Access Charges for Toll Use of
Local Exchange Services, et. al., 87 F.P.S.C. 4:240 (1987)....5,8,9

In re: Petition by the Citizens of the State of Florida for a
Limited Proceeding to Reduce Rates and Charges of United
Telephone Company of Florida to Reflect a Reduction in
Authorized Return on Equity, 88 F.P.S.C. 10:204 (1988).....5

In re: Petition by Citizens of Florida to Compel Compliance
with Rule 25-14.003, F.A.C., by United Telephone Company of
Florida Regarding Calculation of and Method for Refunding 1988
Tax Savings, 89 F.P.S.C. 10:270 (1989)..... 12/13

Florida Statutes

Section 364.14, Florida Statutes (1987)..... 11

Other Authorities

Rule 25-14.003, F.A.C.... 1

**THE PUBLIC SERVICE COMMISSION DESIGNED ITS TAX
RULE TO IGNORE BOTH RATE INCREASES AND RATE DECREASES**

1

The Commission adopted its tax rule (A 1) on June 22, 1982. The rule was designed to deal with situations where federal income tax rates change after completion of a utility's full rate proceeding. That is what happened in this case. United completed its last full rate case in 1982, but the Tax Reform Act of 1986 reduced the corporate income tax rate from 46% to 34% effective July 1, 1987.

There are a number of different ways the Commission could have dealt with changes in federal income tax rates occurring after the completion of a utility's rate case. One choice facing the Commission was to do nothing. In other words, the Commission could have decided to let utilities keep the extra profits they would have earned after a reduction in the federal income tax rate. The Commission chose not to take this route. The Commission could have also required utilities to immediately reduce its rates to exactly offset the change in income tax rates. It chose not to take this approach, either.

I

Rather, the Commission chose to base its tax rule on the earned return on equity of utilities. The rule allows utilities to earn at least their authorized midpoint return on equity before requiring utilities to account for any change in the income tax rate. Under the rule, if a utility earned less than its midpoint

return on equity, even with a reduction in the federal income tax rate, a utility could retain all of its earnings and pass none of the income tax rate reductions back to its customers.

The tax rule also works symmetrically if the federal income tax rate increases. Under the rule, if a utility earns at least its midpoint return on equity, even after paying an increased federal income tax rate, the utility could not charge the higher expense back to its customers. The utility is allowed to charge its customers for the higher tax expense only if it is unable to otherwise earn its authorized midpoint return on equity.

In this way the utility is always assured of the opportunity to earn at least its authorized midpoint return on equity before accounting for tax savings to its customers. In fact, it has the opportunity to earn more than its midpoint return on equity. If the utility would still earn in excess of its midpoint return on equity, even after refunding its tax savings to its customers, the utility is allowed to retain the excess earnings. Likewise, the tax rule prohibits the utility from charging a higher tax expense to its customers if it is able to earn its authorized midpoint return on equity without the extra charge.

Because utilities often change rates through tariff filings, the tax rule purposefully excludes from its operation any consideration of rate increases or decreases. Instead, the rule

is grounded on allowing the utility the opportunity to earn its authorized midpoint return on equity before any action is necessary.

The rule is balanced in its operation by the way it treats both tax expense increases and tax expense decreases. The rule is also balanced by the way it ignores utility rate changes (both increases and decreases). The rule focuses solely on the utility's earnings.

United would rewrite the tax rule to operate only when there have been no rate changes'. The rule is designed, however, to ignore rate changes in favor of assuring a utility the opportunity to earn its authorized midpoint return on equity.

United would also rewrite the tax rule to redefine the term "tax savings²." Rate changes (including rate reductions to long distance companies) have nothing to do with the calculation of tax savings. There is little disagreement that United's tax savings during 1988 was about \$14 million. Yet, even with the rate reduction to long distance carriers, United was still able to earn about \$14 million more than its authorized midpoint return on equity during 1988. It could do this only because the Commission

1

United answer brief at 7.

2

United answer brief at 6.

blocked the refund contemplated by the tax rule to United's customers.

Similarly, the Public Service Commission ignores the purposes served by the tax rule when it argues that a literal application of the midpoint definition and the refund provisions of the rule would yield results contrary to the rule's intent³. During 1988, United earned about \$14 million more than its authorized midpoint return on equity of 13.5%. It refunded none of the tax savings to its customers, yet still earned far above its authorized midpoint return on equity. The intent of the rule would be followed if United were to refund tax savings to the extent it earned above its authorized midpoint return on equity during 1988.

³ PSC answer brief at 13, 14.

**THE RATE REDUCTION TO LONG DISTANCE CARRIERS WAS NOT
DESIGNED TO PASS THROUGH TAX SAVINGS TO CUSTOMERS, NOR WAS IT
IMPLEMENTED IN RESPONSE TO A PETITION FILED BY THE PUBLIC COUNSEL**

United's argues that the rate reduction to long distance carriers was designed for the purpose of refunding tax savings to United's customers⁴. United also argues that this order was issued in response to a petition filed by the Public Counsel⁵. Neither was the case.

The Public Counsel filed two petitions on December 18, 1986, both of which were ultimately dismissed by the Commission. One petition sought to permanently reduce United's authorized midpoint return on equity from 15.75% to 12.25% and to reduce United's rates by \$26 million per year to reflect this reduction in authorized return on equity. This petition (assigned docket no. 861616-TL by the Public Service Commission) was ultimately denied by the Public Service Commission by its order no. 20136 issued October 10, 1988. The other petition filed on December 18, 1986 (assigned docket no. 861615-TL by the Public Service Commission) sought a permanent rate reduction of \$16 million per year to reflect the change in income tax rates. This petition was denied by the Commission's order no. 17429 issued April 20, 1987. A 12.

⁴ United answer brief at 12-13.

⁵ United answer brief at 4, 11-13.

At an agenda conference held three days before the Citizens filed these petitions, the Commission issued a proposed agency action directing all local exchange companies in Florida to reduce the access charges paid by long distance companies. Order no. 17053, issued January 2, 1987, reflected the Commission's December 15, 1986 vote⁶. A 4.

That proposed agency action order was issued in dockets having nothing to do with changes in the federal income tax rates. The dockets in which the order was issued reviewed intrastate telephone access charges for toll use of local exchange services (docket no. 820537-TP) and investigated the recovery of nontraffic sensitive costs (docket no. 860984-TP).

The order did not address tax savings. It did address the difference between the rates charged long distance companies to complete intrastate and interstate toll calls. The Commission decided that the different level of rates charged for intrastate and interstate long distance calls "contributed substantially to the disparity between inter and intrastate MTS and WATS rates." A 5. The Commission decided that the disparity between interstate and intrastate rates alone indicated that there was a problem with the intrastate rate levels that would ultimately encourage bypass

⁶ United argues that the Public Counsel "succeeded in persuading the Commission to reduce rates," but fails to mention that the Commission's vote to reduce access charge rates took place three days before the Public Counsel filed the petition. United answer brief at 13.

and arbitrage. The Commission concluded that "it is clear to us that the increasing disparity between the inter and intrastate rates and the commensurate growth of bypass pressures is a problem that cannot be ignored despite the current lack of widespread bypass." A 6. The Commission decided that "in order to reduce bypass pressures during the pendency of our NTS proceeding, we find it appropriate to require the LECs to reduce intrastate CCL charges effective February 1, 1987." Id.

The Commission was aware of the effect an access charge rate reduction would have on the earnings of local exchange companies. The Commission stated that "while the revenue effect of reducing access charges are of great concern to us, we do not intend at this time to make any specific decisions regarding the recovery of any lost access charge revenues. We believe that, in addition to local rates, each LEC has various additional sources of revenues available to it which may be used to partially or totally offset any lost access charge revenues. As only one example, we note that the Tax Reform Act of 1986 will result in a tax expense savings for each LEC. This savings may offset the access revenue reduction and, if the tax savings is sufficient, a LEC could reduce its access charges as we have directed herein and still suffer no net revenue loss. We reiterate that we are expressly declining to make any provision in this order for any generic mechanisms to offset any access revenue losses." Id. (emphasis added). The proposed

agency action order did not abrogate the operation of the Commission's tax rule in any way.

Thus, the rate reduction to long distance carriers was not designed to offset tax savings. For many telephone companies the level of the access charge rate reduction amounted only to a part of the tax savings. The rate reduction was a response by the Commission to other matters, including bypass pressures and the disparity between interstate and intrastate toll rates. It had nothing to do with the petitions filed by the Public Counsel because the Commission voted on these actions three days before the Public Counsel even filed the petitions frequently cited by United and the Commission in their answer briefs.

United initially protested the Commission's proposed agency action, but it then reached an accord with the staff of the Florida Public Service Commission. Without any hearings and without a stipulation by the Public Counsel', the Commission issued a final agency action order on April 20, 1987, resolving the protest made by United Telephone Company. A 12. The order states that "we will order the disposition of \$7,150,000 associated with United's tax expense reduction for 1987. This will be in lieu of application

⁷ United incorrectly states that the April 20, 1987 order was issued "by concurrence of all parties" (United answer brief at 2, 9) and that an "accord" was reached (United answer brief at 1). Any "concurrence" or "accord" did not include the Public Counsel. The discussions cited at page 2 of the Commission's April 20, 1987 order (A 28, 29) led to an impasse between United and the Public Counsel.

of Commission rule 25-14.003." In addition, it ordered United to increase its depreciation expense by \$568,000 during 1987.

The Public Counsel chose not to appeal this order, although procedurally the issuance of the order was quite odd. In January, 1987, the Commission issued a proposed agency action. United protested that action. Then, without a hearing and without a stipulation by the Public Counsel, the Commission issued a final agency action changing its initial proposed agency action and disposing of United's 1987 tax savings for the first time. It did this even though its proposed agency action order did not purport to dispose of any tax savings at all. There was a stipulation between United and the staff of the Public Service Commission, but there was no stipulation with the Public Counsel.

The 1987 order is not in issue. Rather, the Commission's order dealing with United's tax savings during 1988 and 1989 is the issue. This is the first order wherein the PSC addressed the use of a more reasonable return on equity by United for the tax rule and for other purposes.

The return on equity authorized in United's rate case during 1982 was issued at a time of much greater inflation and much higher interest rates. Lower inflation and lower interest rates led the Public Counsel to petition the Commission to lower United's authorized midpoint return on equity from 15.75% to 12.25%. That

petition was one of the two petitions filed by the Public Counsel on December 18, 1986. The 1988 order addressed the issue of United's authorized rate of return for the first time by actually reducing United's authorized midpoint return on equity to 13.5% for the two year period 1988 and 1989. This order did not follow the approach of the Commission's 1987 order, which ignored return on equity and limited its application to 1987. The 1988 order, on the other hand, addressed return on equity and stated that a new midpoint would be applied for all purposes, including the purpose of following the tax rule, during 1988 and 1989.

The tax rule, for good reasons already discussed, does not consider rate increases or rate decreases implemented by the utility. In all events, it lets the utility earn up to its authorized midpoint return on equity, regardless of any rate changes, before requiring any action by the utility. Then, only if the utility earns more than its authorized midpoint return on equity, the rule requires utilities to refund tax savings to the extent it earns in excess of that midpoint. The Commission's 1988 order said the tax rule would be effective in 1988 and 1989 using an authorized midpoint return on equity of 13.5%. Yet the Commission allowed United to earn far above its authorized midpoint return on equity during 1988 without making the refund required by its tax rule.

ADHERENCE TO THE COMMISSION'S TAX RULE USING A MIDPOINT
RETURN ON EQUITY OF 13.5% PROVIDES UNITED A FAIR RATE OF RETURN

The Commission's reply brief refers to the Commission's statutory responsibility and authority under the provisions of section 364.14, Florida Statutes, to fix reasonable rates and charges for telephone companies in Florida'. In seeming contradiction to its stated purpose, the Commission then argues that a literal application of its 1988 order and tax rule would not set fair and reasonable rates.

Quite the opposite is true. The 1988 order and the tax rule allowed United to earn up to its midpoint return on equity before requiring any tax savings refund to its customers. Application of the tax rule and a 13.5% midpoint return on equity, as required by the 1988 order, is grounded upon allowing a fair and reasonable rate of return to the utility. The Public Counsel did not appeal that order. Later, when the Public Counsel sought enforcement of the 1988 order, the Commission sidestepped enforcement of the order, allowing United to earn \$14 million above its newly authorized midpoint return on equity without requiring any refunds. That is not the scheme developed by the tax rule and the 1988 order.

⁸ Commission reply brief at 14-15.

Instead of enforcing its 1988 order, the Commission developed a step not included in the tax rule. This step was only developed after the Public Counsel asked the Commission to enforce its 1988 order. Without citing any provision of its rule, the Commission stated that "the first step in applying the tax rule is to determine the amount of the company's tax savings and then to determine if any of that amount has been disposed of through Commission action." A 32, 33. This is an insupportable deviation from the tax rule itself. Under the Commission's tax rule, the first step is to look at the utility's earned rate of return -- not to selectively consider one particular rate change and ignore all other rate changes.

CONCLUSION

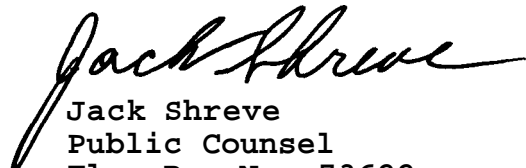
The Commission's 1988 order specifically stated that the Commission would follow its tax rule during 1988 and 1989 using a new midpoint return on equity of 13.5%. By adopting this mechanism, neither rate increases nor rate decreases would determine United's obligation to refund tax savings. The order said nothing about offsetting the refund required by the rule by one rate change and ignoring all other rate changes. It assured United the ability to earn its midpoint return on equity of 13.5% without any obligation to refund tax savings. That same mechanism, however, required United to refund tax savings if it earned above that midpoint return on equity.

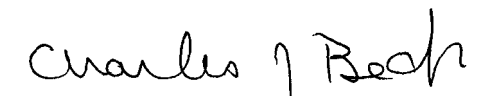
Instead of following the 1988 order, the Commission repudiated it once it was asked to enforce it. The Commission deviated from its 1988 order by allowing United to earn about \$14 million more in 1988 than its authorized midpoint return on equity, while absolving United from its responsibilities under the tax rule.

The Commission should not be allowed to retroactively revise the terms of its 1988 order governing United's obligation to refund tax savings. This Court should direct the Commission to abide by its order and require a refund of United's tax savings during 1988

to the extent United earned above its authorized 13.5% midpoint return on equity during 1988.

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I HEREBY CERTIFY that a copy of the foregoing has been furnished by U.S. Mail or hand-delivery to the following parties this 16th day of March, 1990.

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