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GTE FLORIDA INCORPORATED, Appellant, v. J. TERRY DEASON, ETC., ET AL., Appellee.	CASE NO. 82,003 FPSC DOCKET NO. 920188-TL FPSC DOCKET NO. 920939-TL FILED: SEPTEMBER 3, 1993

ON APPEAL FROM THE FLORIDA PUBLIC SERVICE COMMISSION

INITIAL BRIEF OF APPELLANT GTE FLORIDA INCORPORATED

Thomas R. Parker
Florida Bar No. 449725
James V. Carideo
Joe W. Foster
Kimberly Caswell
M. Eric Edgington
P. O. Box 110, FLTC0007
Tampa, Florida 33601
Telephone: 813-228-3087

Attorneys for
GTE Florida Incorporated

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I. PRELIMINARY STATEMENT

This is an appeal of a telephone rate case decided in Order numbers PSC-93-0108-FOF-TL (Initial Decision), issued on January 21, 1993, and PSC-93-0818-FOF-TL (Reconsideration Order), issued on May 27, 1993, in consolidated Commission Docket numbers 920188-TL and 920939-TL. Those Orders make various findings of fact and conclusions of law concerning certain ratemaking decisions made by the Florida Public Service Commission in establishing the overall revenue requirement and the resulting specific rates GTE Florida Incorporated can charge the public as a result of its 1992 general rate filing.

GTE Florida Incorporated asserts that certain of the findings contained in the above Orders are without legal foundation, depart from essential requirements of law and are not supported by competent and substantial evidence. GTE Florida Incorporated will argue herein the arbitrary and capricious nature of the Commission's decisions on the issues raised on appeal. Specifically, GTE Florida Incorporated seeks judicial review of the Florida Public Service Commission's decisions to disallow legitimate operating costs regarding GTE Data Services, GTE Supply, Statement of Financial Accounting Standards 106 (SFAS 106) as it pertains to the deferral of legitimate expenses associated with post-retirement benefits, and the appropriate equity component in the capital structure. This Court has jurisdiction to review the Orders. Art. V, § 3(b)(2), Fla. Const.; §§ 120.68(2), 350.128(1), and 364.381, Fla. Stat. (1991); Fla. R. App. P. 9.030(a)(1)(B)(ii).

The following major abbreviations are used in this brief. Appellant, GTE Florida Incorporated, is referred to as either "GTEFL" or "Company." Appellee, Florida Public Service Commission, is referred to as "the Commission." The Office of Public Counsel is referred to as "Public Counsel." The Staff of the Florida Public Service Commission is referred to as "Staff." Citations to the record on appeal are designated "R.___." Citations to the transcript contained within the record are referred to as "Tr.___." Citations to the appendix submitted concurrently with this brief are referred to as "A.___."

II. STATEMENT OF THE CASE

On May 1, 1992, GTEFL filed with the Commission proposed tariffs and other documentation required by Florida Administrative Code rule 25-4.141 to initiate a rate case. The Company initially requested an increase in gross annual revenues of $110,997,618, but revised its requested revenue requirement downward on September 3, 1992, to $65,994,207. The Commission suspended the tariffs pursuant to section 364.05 of the Florida Statutes and convened a full evidentiary hearing after extensive discovery was completed. Discovery on the Company included depositions of its major witnesses as well as numerous interrogatories and requests for production of documents. Full intervention status was given to the Office of Public Counsel, AT&T Communications of the Southern States, Inc., Florida Ad Hoc Telecommunications Users Committee, Florida Cable Television Association, Florida Interexchange Carriers Association, Hillsborough County, Intermedia Communications of Florida Inc., MCI Telecommunications Corporation, City of Plant City, Sprint Communications Company, L. P., and Florida Consumer Action Network.

All parties were given the opportunity to submit written direct and rebuttal testimony prior to the hearing. Of all the parties listed above, only Public Counsel submitted comprehensive testimony relating to the establishment of the overall revenue requirement. The Staff presented a witness on only one revenue requirement issue pertaining to changes in calling volumes due to rate changes. The remainder of Staff's evidence concerned the

Company's quality of service. (Tr. 1708, 1720). The Staff also had certain responses to interrogatories and document requests made a part of the evidentiary record. The remaining parties focused their evidentiary presentations on the appropriate rate design to use in producing the revenue requirement to be determined by the Commission.

By Commission Order, the case was heard from October 13 through October 19, 1993. (R. 4995). The hearing was concluded within the time allotted due to an agreement among all parties that large portions of the Company's rebuttal case would be placed in the record without being subjected to cross-examination.[1] (Tr. 1413, 1752).

Due to a heavier than normal Commission rate case docket, the full Commission did not hear the case. (R. 4985). A two-Commissioner panel consisting of Commissioners Thomas Beard and Susan Clark heard and decided the case.[2] Any split opinions between the two Commissioners are required to be resolved by the Chairman pursuant to section 350.01(6) of the Florida statutes and Florida Administrative Code rule 25-22.0355.

The agenda conference establishing the revenue requirement was completed in less than 90 minutes. This decision-making conference

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[1] The testimony of ten Company witnesses was stipulated into the record without cross-examination on the last day of hearing.

[2] Since this case was heard and decided, Commissioner Beard has resigned from the Commission.

covered 99 specific issues associated with the revenue requirement.[3] For example, the SFAS 106 decision, a $10,000,000 issue, was decided quickly, as indicated by the 12 lines of agenda transcript devoted to the issue. (A. 16). During this agenda conference the Commissioners did not actively consider each and every issue. No discussion took place unless a Commissioner had a question on a particular issue. (A. 2).

The Commission's initial decision is contained in Order number PSC-93-0108-FOF-TL, issued on January 21, 1993. (R. 6671; A. 91). This Order denied GTEFL's request for an additional $65,994,207 and, instead, reduced revenues by approximately $14,500,000. Ten million dollars of this reduction is the SFAS 106 adjustment, which is based on the Commission's unsupported opinion of 1994 financial conditions rather than on the established 1992 test year and 1993 rate year contained in the record.

GTEFL filed its Motion for Reconsideration on February 4, 1993. (R. 6815). The agenda conference held to act on the Company's request for reconsideration took less than an hour. Order number PSC-93-0818-FOF-TL, resolving the Motion for Reconsideration, was issued on May 27, 1993. (A. 232). It decreased the negative revenue requirement by approximately $831,000, to $13,500,000. (R. 7282). GTEFL filed its Notice of Appeal with this Court on June 25, 1993. (R. 7317).

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[3] The prehearing order reflects that there are 34 revenue requirement issues. The numerical listing does not reflect that each numbered issue represented a general area of inquiry with the subparts posing separate and specific contested issues.

III. STATEMENT OF FACTS

The Company appeals rulings on four separate accounting issues. These decisions caused the Commission to understate the revenue requirement to which GTEFL is entitled. To enhance the readability of this brief, the facts pertaining to each issue have been placed at the beginning of each argument section of the brief. For the Court's convenience, GTEFL has also included in Appendix A certain portions of the evidentiary record pertinent to SFAS 106.

IV. SUMMARY OF ARGUMENT

This appeal is one of the first instances where the Court has been asked to consider the Commission's oral decision-making process as a part of the appellate record. This has been made possible by this Court's recent opinion in Citizens of the State of Fla. v. Beard, 613 So. 2d 403, 405 (Fla. 1993). GTEFL believes that this expanded appellate record and corresponding insight into the Commission's decision-making process will demonstrate that the Commission has abused its discretion and has engaged in arbitrary and capricious agency conduct.

GTEFL respectfully requests that the Court review the evidentiary record as it decides the merits of GTEFL's arguments. GTEFL is not asking the Court to engage in a de novo review. Rather, examination of the record will reveal that the Commission's orders are not supported by competent and substantial evidence and that the Commission has engaged in arbitrary and capricious agency action in pursuit of an artificially low revenue requirement. The Court should not sanction an exercise of discretion so broad that it lacks support in the record and fails to conform with rational decision-making. The agenda conference transcripts graphically display these weaknesses in the Commission's orders.

GTEFL seeks review of four separate accounting issues associated with its 1992 rate proceeding. The first of these is the Commission's adjustment to disallow approximately $4,600,000 in expenses associated with business transactions between GTEFL and its affiliates, GTE Data Services Incorporated (GTEDS) and GTE

Supply Incorporated (GTE Supply). GTEFL argues that there is no competent and substantial evidence to support the Commission's decision in this area. The agenda conference transcripts provide a unique perspective on the paucity of evidence to support these adjustments, and the confusion associated with the Commission's decision. For example, the agenda transcripts reveal that the Commission knew that there was no difference between the way GTE Supply and GTEDS price services to GTEFL to justify the different adjustments for these two affiliates. Second, GTEFL emphasizes the arbitrary and capricious nature of the Commission order by proving that the Commission relied on misstated precedent in a futile effort to support its affiliated adjustments. Third, GTEFL explains that it is impossible to rationally make a different adjustment for GTEDS and GTE Supply based on the record. Fourth, GTEFL argues that the Commission's decision is arbitrary and capricious because it fails to recognize that GTEFL made the required evidentiary showing on these affiliate issues as mandated by the Commission in its last rate case order for GTEFL. After the Company met the established standard for proving the reasonableness of affiliate transactions, the Commission changed the standard that GTEFL must prove to have affiliate adjustments included in the revenue requirement. The new standard was not revealed to GTEFL until after the hearing. Thus, GTEFL never had a procedural opportunity to satisfy the new standard. Fifth, despite finding that the affiliate relationships at issue benefit GTEFL, the Commission arbitrarily created a new and unattainable burden of

proof that the Company was obliged to meet in order to have the associated expenses included in the revenue requirement.

In regard to SFAS 106, GTEFL argues that the Commission has ignored its own established rules for developing the revenue requirement in a rate case without any explanation of its deviation from established principles or evidence to support its decision. The Commission has reached out in time beyond the approved test period that any party examined or filed evidence on to defer $10,000,000 in expense out into 1994. This decision was made without a proper evidentiary base. In addition to the other deficiencies, the Commission did not provide GTEFL with a fair hearing on this issue. Therefore, the SFAS adjustment also constitutes arbitrary and capricious agency action.

In regard to the capital structure, the Company argues that the Commission's removal of nonregulated investment solely from the equity component of the capital structure, as opposed to a pro rata removal from all sources of capital, is improper for several reasons. First, the Commission's 100% equity adjustment does not reflect how the nonregulated investment was funded in the first instance. Second, removing the nonregulated investment solely from equity ignores other Commission rules which state that a parent's investment position in a subsidiary is presumed to be the same as the subsidiary's capital structure. GTEFL contends that existing Commission rules which announce policy have to be followed in all related areas unless a rational reason has been given to deviate from the policy. Here, none has been given. Finally, GTEFL argues

that the Commission must make similar adjustments for similarly situated utilities. The Commission removed the nonregulated investment for another telephone utility company on a pro rata basis several months before the GTEFL decision. No reason has been given for the different treatment in the GTEFL case, and as such, the Commission has engaged in arbitrary and capricious agency action.

V. ARGUMENT

A. STANDARD OF REVIEW

GTEFL contends that the Commission has made adjustments that are not based on the competent and substantial evidence contained in the record and also that the end result reached on each issue constitutes arbitrary and capricious agency action. GTEFL recognizes that orders of the Commission come to this Court for review clothed with a presumption of validity and that GTEFL bears the burden of proof to show that the order is improper and should be reversed. United Tel. Co. of Fla. v. Mayo, 345 So. 2d 648, 651 (Fla. 1977) and Citizens of the State of Fla. v. Pub. Serv. Comm'n., 425 So. 2d 534, 538 (Fla. 1982). GTEFL is also aware that this Court will not substitute its opinion for that of the Commission merely because a different result could have been reached on the evidence. Gulf Power Co. v. Fla. Pub. Serv. Comm'n., 453 So. 2d 799, 803 (Fla. 1984). Despite these obstacles, GTEFL will show that the decisions on appeal are prima facie examples of improper agency conduct that compel reversal because they are not based on the record and constitute arbitrary and capricious action.

Arbitrary and capricious agency action has been defined in this state in Agrico Chem. Co. v. State of Fla. Dep't of Environmental Reg., 365 So. 2d 759, 763 (Fla. 1st DCA 1979), as follows:

> A capricious action is one which is taken without thought or reason or irrationally. An arbitrary decision is one not supported by facts, logic, or despotic. Administrative discretion must be reasoned and based upon competent and substantial evidence. Competent

> substantial evidence has been described as such evidence as a reasonable person would accept as adequate to support a conclusion.

The definition of competent and substantial evidence was set forth in more detail in De Groot v. Sheffield, 95 So. 2d 912, 916 (Fla. 1957):

> Competent and substantial evidence is "such evidence as will establish a substantial basis of fact from which the fact at issue can be reasonably inferred [or] ... such relevant evidence as a reasonable mind would accept as adequate to support a conclusion.

GTEFL will demonstrate in this brief that these key principles have not been met. Therefore, the Commission's orders must be reversed.

B. GTE DATA SERVICES INCORPORATED

1. STATEMENT OF FACTS

As a part of its rate filing, GTEFL included the costs of its data processing expenses that are integral to running a telephone utility. The Commission disallowed $4,431,863 of these expenses because GTEFL purchases a portion of its data processing needs from an affiliate dedicated to data processing concerns, GTE Data Services Incorporated (GTEDS). The basis for the disallowance was the Commission's decision that, while GTEDS was entitled to a reasonable return, a GTEDS profit level equivalent to what other competitive data processing vendors in the data processing industry were earning was excessive. (A. 159). This finding was made even though the Commission accepted that the Company was receiving an

excellent price from GTEDS. (A. 43). The Commission opined that where there was a non-arms-length transaction with an affiliate, a higher standard of scrutiny was applicable. (A. Id.). The Commission concluded that when an affiliate sells substantially all of its services to a regulated affiliate, its price to the telephone company must be at cost plus a reasonable return. (A. Id.).

The record shows that GTEDS guarantees prices to GTEFL that are equal to or lower than the most favorable rate offered to any nonaffiliate. (Tr. 1416, 2081). The rates charged to GTEFL are derived by reference to actual transactions consummated between GTEDS and nonaffiliated customers. An outside study submitted into evidence as Exhibit 142 demonstrates that GTEDS' rates to the GTE Telephone Operating Companies (GTOCs) for both computer processing and application development are among the lowest in the industry. (Tr. 2093, 2098). The record further reveals that from 1986 to 1991, GTEDS' nonaffiliated business increased an average of 40.2%. Revenues from the nonaffiliated business of GTEDS were estimated to be in excess of $68.6 million in 1992. GTEDS' nonaffiliated business continues to increase at a much greater rate than growth in the data processing industry as a whole. (Tr. 2080). Thus, the prices GTEDS charges to GTEFL are based on charges derived from the competitive market in which GTEDS is successful. This confirms GTEDS' ability to generate outside business and the reasonableness of its prices. (Tr. 2080). A comparison of GTEDS' return with that of its competitors in the data processing industry over the

last five years places GTEDS squarely within industry norms. (Tr. 2081; Ex. 141).

In contrast to the Company's evidence, the Public Counsel presented the testimony of Thomas C. DeWard, a paid consultant employed by Larkin and Associates. Mr. DeWard did no analysis of GTEDS' operations, whether its prices were reasonable, or whether there is a benefit to the Company's ratepayers from GTEFL's relationship with GTEDS. (Tr. 1414-1417). Mr. DeWard did not examine whether the same services could be obtained at a cheaper price by another vendor. Mr. DeWard merely made a mathematical computation reducing GTEDS' earnings down to GTEFL's federal rate of return used by the Federal Communications Commission, due to his own particularized belief that no affiliate should be allowed to earn in excess of the regulated company's return. (Tr. 1415). Mr. DeWard testified he would not have made the adjustment if the exact same dollars were paid to a nonaffiliated data processing vendor earning the same return as GTEDS. (Tr. 1418).

2. THE COMMISSION'S ADJUSTMENT IS NOT SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE.

It is well settled that the Commission's orders must be supported by competent and substantial evidence. Duval Util. Co. v. Fla. Pub. Serv. Comm'n, 380 So. 2d 1028 (Fla. 1980); Citizens of Fla. v. Hawkins, 356 So. 2d 254 (Fla. 1978); City of Plant City v. Mayo, 337 So. 2d 966 (Fla. 1976). Based on this standard there is no evidence to support the conclusion that GTEDS' charges are anything other than proper and prudent.

The only evidence in the record concerning GTEDS' operations and efficiencies came from Mr. Banta, Mr. Reed and Mr. Scudder, all GTEFL witnesses.[4] No party other than GTEFL attempted to determine whether GTEFL could perform the GTEDS functions itself and, if so, whether they could be done in a more cost-efficient manner. No evidence was presented to controvert GTEFL's evidence that these services could not be obtained from another outside source at a cheaper rate. The Staff even admitted that it did not know whether it was better to use an affiliate to perform the data processing function or for the utility to perform the function in-house. (Dec. 16, 1992 Agenda, A. 43). Indeed, Mr. DeWard and the Staff indicated that no adjustment would have been proposed if the same prices were paid by GTEFL to a nonaffiliated entity.[5] (Tr. 1418; Dec. 16, 1992 Agenda, A. 38-39). Even Commissioner Beard stated at the agenda conference that the Company's evidence that GTEDS was doing a good job was uncontroverted. (A. 43). Given these admissions, there is no competent and substantial evidence to support any adjustment. The case law is clear that the Commission cannot simply ignore the uncontroverted facts relating to an expense that will affect future rates. Marco Island Util. v. Pub. Serv. Comm'n,

[4] As noted, Public Counsel witness DeWard merely made an arbitrary mathematical adjustment to the return. He did no analysis of GTEDS' actual operations.

[5] It is interesting to note that in the 1981 case GTEDS expenses were not adjusted even though GTEDS did not have the level of nonaffiliated business that it enjoys today. Petition of Gen. Tel. Co. of Fla. to Increase Its Rates and Charges, 81 F.P.S.C. 11:233 (1981).

566 So. 2d 1325, 1329 (Fla. 1st DCA 1990).

The foundation of the Commission's adjustment is the finding that the GTEFL/GTEDS relationship is not arms-length, such that the return should be reduced to cost. (A. 159). There is no support in the record for this conclusion. The Reconsideration Order states that the "decision was based on the record which included considerable testimony and cross-examination on the nature of the transactions." (A. 235). As the record indicates, the overwhelming majority of the evidence and cross-examination came from the Company, revealing the weaknesses of Public Counsel's witnesses' position. Mr. DeWard's conclusionary recommendation was made without any support or analysis. His testimony on this specific adjustment is just 17 lines long plus one schedule. (Tr. 1327).

The Commission cannot rely upon the unsupported opinions of experts. Mr. DeWard's testimony is a classic example of an expert witness giving an opinion without any evidentiary showing of the facts upon which the opinion is predicated. The Commission's decision must be based on the facts in evidence and not merely on expert opinions which are not supported by the facts. Hamm v. Southern Bell Tel. and Tel. Co., 394 S.E.2d 311, 313 (S.C. 1990). The Commission's reliance on Mr. DeWard's advice is especially improper given the following facts which were established in the record: 1) he performed no substantive analysis; and 2) he admitted that the party who hires him has the ability to tell him what the content of his testimony will be. (Tr. 1415, 1427-1428).

Moreover, the Commission did not even consider the Company's evidence in making its decision. In its Reconsideration Order, the Commission remarks:

> We note that the evidence cited by the company regarding the quality of the services provided was never an issue, was not disputed, and is not the basis of the adjustment. (A. 233).

The Commission cannot plausibly make a $4,431,863 adjustment without considering the Company's evidence. This omission makes the decision arbitrary and capricious, in violation of the <u>Agrico</u> standard.

As noted, the Commission Staff and Public Counsel agree that no adjustment would be made if the same expenses and resulting return were paid to a nonaffiliated entity. Thus, if the same dollars were paid to Electronic Data Services, a nonaffiliated entity, the expense would be allowed and the $4,431,863 adjustment would not be made. Whether an expense is proper for ratemaking purposes should not depend on the identity of the party to whom the expense is paid. This is a prima facie case of a decision that is not supported by competent and substantial evidence and is also arbitrary and capricious agency action.

3. <u>THE COMMISSION'S CITATION OF AUTHORITY DOES NOT SUPPORT ITS ORDER.</u>

In its Order on Reconsideration, the Commission states that its decision to reduce GTEDS' return to cost plus the interstate

return is supported by prior Orders of the Commission. To this end, it cites GTEFL's last fully completed rate case and a recent rate case of United Telephone Company of Florida. (A. 234). These Orders, however, do not support the GTEDS adjustment. In Petition of Gen. Tel. Co. of Fla. to Increase Its Rates and Charges, 81 F.P.S.C. 11:233, 250 (1981), the Commission stated that GTEFL would be expected to present specific costs of both affiliated services and outside alternatives in future rate cases. The purpose of requiring this showing was to demonstrate the prudency and reasonableness of the transactions. 81 F.P.S.C. 11 at 242. GTEFL fully complied with this directive in its evidentiary presentation as summarized in the Statement of Facts.

Further, the recent United rate case, Application for a Rate Increase by United Tel. Co. of Fla., 92 F.P.S.C. 7:555 (1992), cannot serve as precedent for the Commission's action in this case. The United Order does not contain any adjustment reducing a market-based return to cost plus the interstate rate of return. These inconsistencies and errors in the Commission's order further show the arbitrary and capricious nature of the Commission's decision.

4. THE COMMISSION'S GTEDS ADJUSTMENT IS ARBITRARY AND CAPRICIOUS BECAUSE IT IS INCONSISTENT WITH A SIMILAR AFFILIATED ADJUSTMENT MADE FOR GTE SUPPLY.

Assuming, arguendo, that there were a basis for some sort of GTEDS adjustment, it must be done consistently with other, similar

adjustments made in the case.[6] GTEDS provides services to GTEFL in a manner identical to that of GTE Supply, a GTEFL affiliate devoted to material and supply procurement. The Commission, however, failed to treat GTEFL's transactions with its affiliates in a consistent manner. As such, it is not a reasoned decision nor is it supported by facts or logic as required by the Agrico case.

GTE Supply is a GTEFL affiliate that provides numerous materials and supplies necessary to run the business. GTEFL purchases these items from GTE Supply at market, or prevailing, price, just as it purchases data processing from GTEDS on this basis. (Tr. 1893, 1896, 2068-70). Annually, GTE Supply obtains over $100 million in revenue from sales to over 2,000 nonaffiliated customers.[7] (Tr. 1420, 1880, 1890-91, 1895, 1898). Moreover, GTEFL's respective contracts with GTE Supply and GTEDS both ensure that GTEFL will receive prices at least as favorable as those offered to nonaffiliated entities. [8] (Tr. 1890, 1899). An independent study demonstrated that the GTE Telephone Operating Companies receive more favorable prices from GTE Supply and from GTEDS than they could from other vendors. (Tr. 1912-15).[9]

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[6] GTEFL opposes any adjustment in any form relating to GTE Supply and GTEDS expenses for the reasons stated in this Brief.

[7] GTEDS had nonaffiliated business of $68.2 million in 1992. (Tr. 2080).

[8] GTEDS guarantees prices to GTEFL that are equal to or lower than the most favorable rate given to a nonaffiliate. (T. 1416).

[9] Exhibit 142 shows the same result for GTEDS.

Public Counsel witness DeWard made identical recommendations regarding GTEDS and GTE Supply. He proposed a reduction of these affiliate returns to the overall FCC return of 11.25%. In both cases he performed no examination of whether these affiliates provided greater benefits than those that could be obtained elsewhere on the open market. (Tr. 1419).

In regard to the GTE Supply adjustment, the Commission considered at the agenda conference whether a complete adjustment of GTE Supply's return down to the FCC 11.25% return was appropriate and whether such an adjustment would send appropriate signals to GTEFL in making future business decisions. The Commission decided that an adjustment of GTE Supply's profit level down to the FCC return was not appropriate because there were savings and efficiencies inherent in the affiliate process. (A. 159). The adjustment, as proposed by Staff and Public Counsel, would be a signal to GTEFL to dissolve all affiliate relationships and to set up its own in-house supply function. (Dec. 16, 1992 Agenda, A. 34-49). The Commission stated that a complete adjustment would give GTEFL an incentive to set up an in-house function for ratemaking purposes regardless of whether it was in the best interests of the ratepayers or whether it was the correct economic decision. Based on this discussion, the Commission "split" the amount of the proposed GTE Supply adjustment to recognize the efficiencies associated with the affiliate relationship and to avoid sending the wrong signal to GTEFL. (Dec. 16, 1992 Agenda, A. 49).

Assuming any adjustments are to be made, the evaluation process must be the same for both GTEDS and GTE Supply. Any other result is arbitrary and capricious. Both affiliates use market-based pricing, have substantial nonaffiliated business and earn profits above the FCC level. If the Commission was concerned about the signals a substantial adjustment would send regarding GTE Supply, the same concerns apply with equal force to GTEDS based on the similarity of the two affiliates. Therefore, the Commission should have used the same method for GTEDS that it used for GTE Supply. It should have refused to make the adjustment as proposed and reduced the intrastate portion of the recommended $4,409,268 GTEDS adjustment by at least half, to $2,204,634. Otherwise, based on the Commission's analysis, the Company would be motivated to move data processing in-house with the loss of accompanying efficiencies, to the detriment of consumers.

The Commission bears the burden of providing a reasonable explanation for inconsistent results based on similar facts. A failure to do so violates the Administrative Procedures Act and the equal protection guarantees of the Florida and federal constitutions. St. John's North Util. Corp. v. Fla. Pub. Serv. Comm'n, 549 So. 2d 1066, 1069 (Fla. 1st DCA 1989). No explanation appears in the Orders in this case for the difference between the GTEDS and GTE Supply adjustments. This makes the adjustment arbitrary and capricious. The transcript of the agenda conference which resolved GTEFL's Motion for Reconsideration supports this conclusion:

COMMISSIONER CLARK: Explain to me--just explain to me what the difference--the argument between what we did with GTEDS and GTE Supply.

MS. JOHE: The decision the Commission made on GTE's Supply was to split the excess profit, which excess profit is defined as any profit above 11.25 that sets GTE's rates.

COMMISSIONER CLARK: Because we wanted to continue to encourage them to engage in that efficient cost-effective--

MS. JOHE: That's correct, right. And so what the Commission did was split that profit, excess profit into two and disallow only half of it. Whereas, for GTE DATA Services, the entire amount of--the excess amount of 11.25 was disallowed.

COMMISSIONER CLARK: And what was the rationale for not doing that with GTEDS? I remember these discussions, but I don't remember the particulars of them.

MR. DAVIS: There was extensive discussion on the Supply issue, but <u>there was very little discussion on the Data Services issue. And I don't believe an actual reason was articulated one way or the other.</u>

MS. JOHE: The rationale that Staff used for having different decisions is that the Commission has every right to make one decision and, you know, different decisions. Just because we made one decision on GTE Supply, doesn't mean that we have to make the same decision for all of its affiliate companies.

(A. 72-73) (emphasis added).

The Commission's decision is clearly not based on appropriate evidence and is devoid of any logical rationale. The Commission did not even consider whether there was any meaningful difference between the affiliates. This is particularly troubling given the fact that Commissioner Clark stated there was validity to the Company's position at the May 4, 1993, agenda conference and that she was inclined to treat Supply and GTEDS the same. (A. 74).

Again, the record demonstrates that the decision making process was not reasoned, logical or supported by the evidence as required by the Agrico case.

The record reveals no reason for any GTEDS adjustment, let alone acceptance of the Staff's extreme recommendation. If the Court, however, determines that the Commission was justified in making some adjustment, the process should be consistent with the GTE Supply analysis. Different treatment for GTEDS and GTE Supply must be justified in the record and explained. Otherwise, the GTEDS adjustment is arbitrary and capricious.

5. THE COMMISSION'S ORDER IMPROPERLY CREATES A NEW POLICY.

In GTEFL's last rate case in 1981, the Commission set forth the test the Company has to meet to include affiliated transactions in the revenue requirement calculation. In particular, it stated:

> It is apparent to us that certain efficiencies and related benefits flow from the vertically integrated relationship occupied by General Telephone and Automatic Electric within the GTE System. Whether the fair proportional share of these benefits accrue to General Telephone's Florida subscribers is another concern. We are aware of the potential for abuse through predatory pricing and cross-subsidization practices inherent in the context of affiliate purchases. In view of the present movement to a competitive equipment and supply market sector in the telecommunications industry, concerns regarding procurement practices of the telephone companies must occupy an ever greater position of importance. For these reasons, we are inclined to require better cost and price justification for affiliate purchases in subsequent proceedings. More explicit price comparisons and evidence of active outside bid solicitations should accompany future transactions to ensure reasonableness and prudency therein.

> Notwithstanding these concerns, we are not persuaded based on the record in this proceeding to make any adjustment.

Petition of Gen. Tel. Co. of Fla. to Increase Its Rates and Charges, 81 F.P.S.C. 11:233, 242 (1981) (emphasis added).

Likewise, in regard to other affiliate relationships, the Commission stated:

> In future cases, we would prefer to have the precise services utilized in Florida and the direct cost of providing those services, along with other outside procurement alternatives for obtaining the services. A showing of the reasonableness and prudency of particular expenditures would, in our estimation, be preferable to the "blanket-savings" approach now utilized and would be the preferred method for the Company to use to demonstrate the value of license contract services relative to rising costs for such services.

81 F.P.S.C. 11 at 252 (emphasis added).

GTEFL structured its evidentiary presentation in this case to meet the specific requirements established by the Commission in 1981 for the evaluation of affiliate transactions in future GTEFL rate proceedings. GTEFL does not take issue with the Commission's view that affiliate transactions are subject to a higher standard of scrutiny. (A. 159). However, GTEFL must be put on notice as to what the higher level of scrutiny is and how it can be satisfied. The emergence of some new, undefined level of scrutiny and new elements of proof established on a post-hearing basis is wholly unacceptable. Furthermore, the Commission did not give any explanation as to why the old standard is not applicable. The failure to provide GTEFL with adequate notice of a change in the standard it must satisfy to include affiliated transactions in the revenue requirement constitutes arbitrary and capricious agency

action. The Company cannot be expected to satisfy its burden of proof when that burden changes from rate case to rate case, particularly after the evidentiary portion of the case has closed.[10]

The record, as summarized supra, unequivocally demonstrates that the Company satisfied the established burden of proof pertaining to affiliated relationships. While GTEFL recognizes that the Commission can change policy as it deems fit, Investigation into Equal Access Exchange Areas, Toll Monopoly Areas, 1+ Restriction to the Local Exchange Companies and Elimination of the Access Discount, 89 F.P.S.C. 3:65 (1989), it must be given the opportunity to have input into that policy change and know what it must demonstrate to the Commission to reach a satisfactory result. If it does not, procedural due process has been violated and the Commission has engaged in arbitrary and capricious agency action. Austin Tupler Trucking, Inc. v. Hawkins, 377 So. 2d 679 (Fla. 1979) and Falls Chase Special Taxing Dist. v. Dir., Fed. Emergency Management Agency, 580 F.Supp. 967 (N.D. Fla. 1983).

The principles underlying the Florida case law have been applied in other jurisdictions in specific ratemaking examples. In Gen. Tel. Co. of the Southwest v. N. M. Pub. Serv. Comm'n, 652 P.2d 1200 (N.M. 1984), the New Mexico Supreme Court reviewed a New Mexico Public Service Commission ruling changing its method of computing cash working capital from its past practice without

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[10] The Commission claims that it is not creating policy but is merely following adjustments consistent with prior decisions. As demonstrated in Section B3, supra, these prior decisions are not on point.

proper notice or reasonable justification in the record. In holding against the Commission, the Supreme Court found that the record did not reflect prior notice to the Company of any "changed circumstances" affecting the method of calculating cash working capital since prior orders approved the method utilized by the company. The Court conceded that a commission should be able to change its procedures as necessary; however, it should not do so arbitrarily or capriciously, without notice and good reasons.

The West Virginia Supreme Court was faced with a similar issue in Chesapeake & Potomac Tel. Co. of W. Va. v. Pub. Serv. Comm'n of W. Va., 301 S.E.2d 798 (W.Va. 1981). The West Virginia Public Service Commission made a decision which deviated from the requirements of its administrative rules. The Court reversed the Commission on the manner in which it implemented its new methodology. The Court pointed out that the utility was not informed of the new method until almost seven months after its case was filed and three weeks before hearings were to commence. It concluded as follows:

> The public utilities used these rules to plan their proofs in rate cases. And, of course, their rate cases found their survival. Utilities have no vested right to any particular approach, but they have a right to application of the current, effective rules to their rate filing, absent reasonable notice (here only three weeks) that another rule would be contended for by the commission staff.

In Boston Edison Co. v. Fed. Power Comm'n, 557 F.2d 845 (D.C. Cir. 1977), the United States Court of Appeals for the District of Columbia ruled that it is essential for an administrative agency to give notice of and a reasonable rationale for a change in standards

before it is implemented. Furthermore, such changed standard may be applied to parties only after it has been proclaimed as in effect. The Court of Appeals also held that while an administrative agency is not bound to rigidly adhere to its precedents, it is essential to give adequate notice of a policy reversal and the changed standard will only apply to those actions taken after the new methodology has been implemented. The Florida Public Service Commission has violated all of these general principles in this case.

6. THE COMMISSION'S NEW POLICY CREATES AN IMPROPER BURDEN OF PROOF.

The Commission's Order states that one reason for the GTEDS adjustment is that GTEDS does not conduct enough nonaffiliated business to justify the return earned. (A. 105). This conclusion is unfounded and places GTEFL in a position where it cannot satisfy its burden of proof.

The Commissioners in their oral discussions realized that there are efficiencies and savings pertaining to affiliated transactions because large volumes produce significant discounts. (Dec. 16, 1992 Agenda, A. 37). Against this analysis is the finding in the Order that GTEDS and GTE Supply do not do enough nonaffiliated work.[11] Thus, instead of looking at the merits of the matter, the Commission's decision is based on a comparison of the percentage business a utility does with the affiliate.

[11] In making this finding the Commission did not state what constitutes the proper amount of nonaffiliated business.

The Commission has used an arbitrary and capricious quantification of benefits after recognizing that benefits do flow to the ratepayer. The percentage approach does not demonstrate whether GTEDS provides benefits to the regulated ratepayer or whether it is providing the service at the appropriate cost. The Company's evidence does. If GTEDS' nonaffiliated business is only examined in terms of percentages and not absolute dollars, it is a mathematical truism that the Company will not be able to meet the Commission's test.[12] As recognized by the Commission, the savings realized by a utility from purchasing from affiliated entities flow from the economies of scale associated with providing service to the GTE Telephone Operating Companies' 15.9 million access lines. (A. 38). Nonaffiliated business as a percentage of the affiliate's total business will be predictably less than the GTOC business given the mathematics involved.

The percentage approach is improper as demonstrated by the record. GTEDS has some of the highest growth in the data processing industry and its rates are some of the lowest. (Tr. 2093, 2080). These facts demonstrate that if the Commission wants to look at information in addition to the benefits GTEDS produces to ratepayers it is arbitrary to look at GTEDS in anything except in terms of the absolute dollar value of its nonaffiliated business--

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[12] Indeed, the Commission has not yet stated what constitutes the appropriate threshold percentage.

$68,000,000--not as a percentage of total business.[13] When viewed in this way, $68,000,000 of nonaffiliated business is substantial and appropriate to determine whether the level of cost being paid by GTEFL is prudent. The Commission cannot state that there are benefits to an affiliate situation and then devise a standard that cannot be met. To do so makes the Commission's decision arbitrary and irrational under the Agrico principles.

C. GTE SUPPLY

GTEFL seeks reversal of the adjustment pertaining to GTE Supply for the same reasons applicable to GTEDS under Argument sections B.2, 3, 5 and 6, supra. GTEFL respectfully directs the Court to the above points to avoid unnecessary redundancy. First, GTEFL argues that there is no competent and substantial evidence to support the Commission's decision in this affiliated area. Second, the Commission's adjustment is not supported by its citation of authority. Third, the Commission's decision is arbitrary and capricious because it ignores that GTEFL made the required evidentiary showing on these affiliate issues as mandated by the Commission in its last rate case order for GTEFL. Fourth, despite finding that the affiliate relationships benefit GTEFL, the Commission arbitrarily created a new and unattainable burden of proof to have the associated expenses included in the revenue requirement. GTEFL sets forth a statement of facts pertaining to

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[13] In addition, the Order states no reason as to why the percentage approach is reasonable.

GTE Supply below.

1. <u>STATEMENT OF FACTS</u>

GTEFL purchases materials and supplies from GTE Supply at market, or prevailing, price. (Tr. 1893, 1896, 2068-70). Annually, GTE Supply obtains over $100 million in revenue from sales to over 2000 nonaffiliated customers. (Tr. 1420, 1880, 1890-91, 1895, 1898). About one-sixth of total sales are to third parties. (Tr. 1898). Because of this volume of nonaffiliate business, GTE Supply is able to grant the GTOCs a discount about 2.5% to 3% lower than it could otherwise. (Tr. 1912, 1891). Moreover, GTEFL's contract with GTE Supply ensures that GTEFL will receive prices at least as favorable as those offered to nonaffiliated entities. (Tr. 1890, 1899). In fact, GTE Supply's prices to GTEFL average 13.67% lower than the rates charged to nonaffiliated customers. (Tr. 1420, 1887, 1891, 1895). An independent study demonstrated that the GTOCs receive more favorable pricing from GTE Supply than they could from other vendors. (Tr. 1912-15). Specifically, GTE Supply's prices to its GTOC affiliates are about 12% lower than the average of the two lowest-priced competing vendors and about 21% lower than the average of all vendors combined. (Tr. 1915).

In contrast to the Company's evidence, the Public Counsel presented the evidence of Thomas C. DeWard. Mr. DeWard did no analysis of GTE Supply operations, whether its prices were reasonable, or whether there is a benefit to the Company's rate payers from GTEFL's relationship with GTE Supply. (Tr. 1419-1420).

Mr. DeWard did not examine whether the same services could be obtained at a cheaper price by another vendor. He merely made a mathematical computation reducing GTE Supply earnings down to GTEFL's federal rate of return used by the Federal Communications Commission, due to his own personalized belief that no affiliate should be allowed to earn in excess of the regulated company's return. Mr. DeWard testified he would not have made the adjustment if the exact same dollars were paid to a nonaffiliated vendor earning the same return as GTE Supply. (Tr. 1418).

No party has offered evidence to refute the demonstrated benefits derived from GTEFL's relationship with GTE Supply. The Commission has not presented any evidence to support its adjustment. The Company has satisfied the requirements prescribed by the Commission in its last rate case. Thus, the Commission's adjustment is arbitrary and capricious and should be reversed.

D. STATEMENT OF FINANCIAL ACCOUNTING STANDARD 106

1. STATEMENT OF FACTS

A major accounting issue in this proceeding affecting the revenue requirement was whether the Commission should adopt Statement of Financial Accounting Standards 106 (SFAS 106) entitled "Employers Accounting For Post-Retirement Benefits Other Than Pensions." This accounting pronouncement requires major corporations to book post-retirement benefits, such as medical insurance, on an accrual basis as opposed to the existing cash basis approach. (Tr. 753). SFAS 106 is designed to produce a better matching of

the expenses associated with offering these post-retirement benefits. (Id.). Under SFAS 106, such expenses will be incurred over the life of the employee, as opposed to recognizing the expense as it is incurred upon retirement. SFAS 106 recognizes that it is important to appropriately reflect the ongoing costs of the firm in light of the significant increases in these expenses as time progresses.

The Commission found that the implementation of SFAS 106 was appropriate for book and ratemaking purposes. However, it deferred $10,000,000 out of $21,000,000 in SFAS 106 costs from the rate year and ordered that these expenses be recognized starting in 1994. (A. 107). This part of the SFAS 106 expense was not recognized for ratemaking purposes. The Commission felt that GTEFL would experience increased earnings in 1994 to offset this level of expense and that increased rates were not necessary to recoup these known costs. It is the deferral portion of the adjustment which is the subject of this appeal.

The relevant evidentiary record on this topic is contained in Appendix A starting on page 267. These four pages of cross-examination are the only direct testimony in the record concerning this $10,000,000 issue.[14] The Commission found that $10,000,000 of SFAS 106 costs could be deferred into the future on an unproven assumption that held the growth rates constant for all of the

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[14] There is other evidence in the record regarding SFAS 106; however, it pertains to whether the pronouncement should be adopted, not whether it should be funded for ratemaking purposes based on the future earnings of the Company.

expense, revenue and investment components from 1993 to 1994, while recognizing that the burden shift of costs from the interstate to intrastate jurisdictions mandated by the Federal Communications Commission was completed in 1993. (A. 108-109). Based on this analysis, the Commission found earnings would increase in 1994 and that rates were not necessary to cover this expense.

2. THE SFAS 106 DEFERRAL IS NOT SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE.

The case law pertaining to competent and substantial evidence cited in Section A of this Brief is equally applicable to this issue. The evidence must be of the quality that a reasonable person would accept it as adequate to support a conclusion in the due course of business.

GTEFL cannot cite to the Court any meaningful evidence in the record to support the assumption that the growth relationships in revenue, expense and rate base will remain constant in the future, because there is no evidence to support this assumption utilized by the Commission. Public Counsel witness DeWard testified that he had not done an analysis of GTEFL's intrastate earnings for 1994. (Tr. 1443). Indeed, he admitted that he did not have any budgeted information for 1994. (Id.) The Staff did not present a witness on this topic. The entire record devoted to this topic was a few generic questions to Mr. DeWard and GTE witness Johnson. (Tr. 1443, 1841). Mr. Johnson stated he did not know what the changes in 1994 would be. (Tr. 1872). Indeed, Mr. Johnson stated that he was not aware of any facts that would cause the Company's net

operating income to rise in 1994. (Id.). Moreover, Mr. Johnson's direct testimony contained an attrition study that examines the propensity of the Company's earning to change over time. That study, which was never challenged during the hearing, shows that GTEFL's earning will decrease in future years. (Tr. 780). However, there was never any specific examination regarding the specific conditions that would exist in 1994.

A few broad questions regarding the general condition of the Company in 1994, a period not under review by any party to the case, do not produce the quantum of evidence necessary to support the SFAS 106 deferral. This is especially true given the uncontested attrition study which showed a decline in earnings over time. Certainly, these questions are no substitute for the detailed analysis of GTEFL's 1994 earnings situation that would be necessary to build an appropriate evidentiary foundation for such a substantial adjustment. This lack of testimony and analysis indicates the uncertainty of the 1994 earnings picture and why the Commission had no support for its adjustment. As such, the Commission's base assumption is not supported by competent and substantial evidence. The Commission cannot base its decision on undisclosed factors. North Fla. Water Co. v. Marianna, 235 So. 2d 487, 489 (Fla. 1970).

3. THE COMMISSION'S DECISION VIOLATES ALL ESTABLISHED TEST YEAR CONCEPTS, RATEMAKING POLICY AND RELEVANT CASE LAW.

Florida Administrative Code rule 25-4.140, entitled "Test Year Notification," requires a utility to notify the Commission of the

test year it intends to utilize and explain why it is representative for ratemaking purposes. GTEFL did so and the Commission found the Company's proposed 1992 test year and 1993 rate year to be appropriate. (A. 102). In authorizing the test year, the Commission specifically found that the 1993 rate year would capture the significant events resulting from the implementation of SFAS 106. By deferring a portion of the SFAS 106 costs into the future, the Commission violated its own finding that the 1992 test year is appropriate and that the 1993 rate year takes into account post-retirement benefits.

The purpose of a test year is to accurately match all items of revenue, expense and investment in order to produce the typical conditions the utility will likely face in the first year after the rates are established. Gulf Power Co. v. Bevis, 289 So. 2d 401, 404 (Fla. 1974). An accurate relationship between costs and revenues in the test period is one of the most vital factors in the determination of just and reasonable rates. Failure to match rate base, revenues and expenses distorts the test year and will thus distort the Commission's assessment as to a reasonable rate structure. The test year is used to measure the adequacy and reasonableness of a utility's rates. Southern Bell Tel. & Tel. Co. v. Fla. Pub. Serv. Comm'n, 443 So. 2d 92, 95 (Fla. 1983).

Here, the Commission has ignored a known and quantifiable liability in the rate year and instead engaged in bare speculation about conditions beyond the rate year. This conduct violates the prohibition against the Commission making adjustments based on out-

of-period general economic conditions. The Commission does not have unlimited authority to adjust for out-of-period items relating to general economic decisions. As stated in Broward County Traffic Assoc. v. Mayo, 340 So. 2d 1152, 1153 (Fla. 1977), the Commission may go beyond the test period to recognize known and ascertainable liabilities. It cannot, however, go outside the test year to adjust for undocumented assumptions/projections as to general economic conditions. To do so would obviate the use of test years as a tool in ratemaking. The Commission's decision in this case was thus directly opposed to the holding in the Broward County case.

No witness in the case claimed any knowledge of the detailed financial condition of GTEFL during 1994. As such, the 1994 earnings position of the Company is not known and measurable and therefore cannot be the basis of a $10,000,000 adjustment. In fact, many events that may occur in 1994 could negatively affect the Company's earnings. These include, for example, an increase in the federal corporate income tax rate, implementation of family leave legislation, socialized health care tax, new accounting pronouncements, collocation issues and changes in rules for separating state and federal costs.

In this case, the Commission has disallowed a known and ascertainable liability based on speculation regarding the general economic or earnings position of the Company in 1994. If the Commission wanted to consider projected 1994 earnings, it should have at least ordered evidence to be produced regarding out-of-

period conditions, as it has done in other proceedings. For example, in the recent United case, discussed supra, the Commission based its decision to defer SFAS 106 costs beyond the approved test year based on a complete analysis of the associated budget for such period. There, the Public Counsel had objected to the proposed test year on grounds of unreliability. To remedy this problem the Commission examined the complete 1993 budget of United. United was even ordered to refile some of its initial documentation based on out-of-test period information. United, supra, 92 F.P.S.C. 7 at 561. The Commission's decision in United was based on a complete evidentiary record.

For this reason, the United case fails to support the Commission's action here. Commissioner Clark asked at the agenda conference whether the SFAS 106 adjustment was consistent with what they had done in the United case. The Staff replied that it was. (A. 16). This is another example of arbitrary and capricious agency action. The end result--an adjustment--may be the same, but no attempt was even made to analyze whether the evidentiary record supported this result for GTEFL.

To counter charges that it violated the test year concept, the Commission relies on several electric company cases where dual test years and step rate increases have been used. (A. 239). It is correct that the Commission used a multi-year analysis in recent Florida Power Corporation and Tampa Electric Company rate cases. Petition for a Rate Increase by Fla. Power Corp., 92 F.P.S.C. 10:408 (Fla. 1992) and Application for a Rate Increase by Tampa

Elec. Co., 93 F.P.S.C. 2:45 (Fla. 1993). However, the Commission's reliance on these cases is misplaced.

The electric cases are inapposite for a basic reason. There, the Commission did a complete financial analysis for all periods analyzed, and all parties were put on notice as to what the rules were at the beginning of the process. This was not done in GTEFL's case. Thus, the cases provide no legal basis for the Commission's deferral of a legitimate expense beyond the test year for a telephone company being regulated under traditional rate of return regulation under Florida Statutes Chapter 364.

4. THE COMMISSION'S ACTION VIOLATES THE COMPANY'S PROCEDURAL AND SUBSTANTIVE DUE PROCESS RIGHTS.

The Commission's action violates the Company's rights to procedural due process as guaranteed by the Fourteenth Amendment to the United States Constitution and Article I, Section 9 of the Florida Constitution, in that GTEFL has not received a fair hearing on this issue. The amount of hearing time devoted to this topic was minimal, as demonstrated by Appendix A. The Staff's position regarding the appropriate resolution of this issue was not known at the time of hearing. (R. 5699). This issue has not been handled in a manner which allowed GTEFL to learn and effectively rebut any adverse allegations. The rudiments of fair play require an opportunity to explain or rebut matters at issue. Fla. Gas Co. v. Hawkins, 372 So. 2d 1118, 1121 (Fla. 1979). Further, Section 120.57 of the Florida Administrative Procedures Act gives GTEFL the statutory right to respond to the issues and to present evidence

and argument on all issues before the Commission. GTEFL could not, of course, address positions that were not known at the time of hearing. Therefore, GTEFL's procedural due process rights have been violated.

The Company's substantive due process rights were violated because the Commission has confiscated the Company's property through the deferral of SFAS 106 costs. The Commission has placed the burden of $10,000,000 of SFAS 106 costs on GTEFL shareholders. It has directed GTEFL to defer $10,000,000 and to record the amount as a regulatory asset. Under this method, GTEFL will amortize the asset over a four-year period. This delays the recognition of part of the SFAS 106 costs until after the test year without any corresponding rate relief. Because a portion of SFAS 106 costs was not recognized in setting rates, GTEFL's return will be reduced starting in 1994 due to the unfunded amortization. This result will happen each and every year until the expense is recognized in setting rates. Thus, the earnings to which the shareholder is entitled will be diluted to absorb this cost. By deferring $10,000,000, the Commission is confiscating the Company's property.

The only remedy available to the Company to alleviate this situation is to file a subsequent rate case application to recover this cost or other costs that it cannot absorb because rates have been set too low. However, GTEFL can never recoup the $10,000,000 due to the prohibition against retroactive ratemaking. Southern Bell Tel. and Tel. Co. v. Fla. Pub. Serv. Comm'n, 453 So. 2d 780 (Fla. 1984). The proper approach consistently used by the

Commission is to allow all aspects of cost of service in the revenue requirement calculation and rely on the ongoing earnings surveillance process to monitor the earnings situation. The Commission's departure from this longstanding practice is improper.

E. CAPITAL STRUCTURE

1. STATEMENT OF FACTS

GTEFL has a wholly owned subsidiary, GTE Communications Corporation (GTECC), that is in the business of providing deregulated offerings such as customer premises equipment. GTECC was created pursuant to an express order of this Commission in 1985. Petition of Gen. Tel. Co. of Fla. for Approval of the Transfer of Embedded Customer Premises Equipment and Maintenance and Installation of Inside Wire to a Separate Subsidiary, 85 F.P.S.C. 3:336 (1985). In the rate case, the Commission had to remove GTECC from the capital structure in order to set regulated rates based on that portion of the capital structure that corresponds to the regulated investment. The issue on appeal is how the removal should be accomplished.

The Commission removed the investment associated with GTECC from GTEFL's capital structure 100% from the equity component in order to establish the regulated capital structure to be used for ratemaking purposes. (A. 123). The Commission opined that this treatment was appropriate to offset the higher risk associated with unregulated operations. (Id.). GTEFL proposed that the unregulated investment be removed from all permanent sources of capital (i.e., long term debt, preferred stock, and equity) in a pro rata manner

because funds used to finance nonregulated investment cannot be traced to their point of origin. (Tr. 1762). GTEFL presented evidence establishing that a pro rata removal more accurately reflects the actual financing of GTEFL's nonregulated investments (Id.).

2. REMOVAL OF GTECC ENTIRELY FROM EQUITY IS ARBITRARY AND CAPRICIOUS BECAUSE IT IS INCONSISTENT WITH OTHER COMMISSION REQUIREMENTS PERTAINING TO THIS SUBJECT MATTER.

The Commission's decision on this issue is contrary to long-established Commission rules pertinent to other, similar parent/subsidiary relationships and how capital structures are determined for ratemaking purposes. GTEFL submits that the removal of its unregulated subsidiary from the capital structure must be done in a manner consistent with other established rules pertaining to when items of the parent's capital structure are imputed to GTEFL when it (rather than GTECC) is in the subsidiary position. The Commission's application of these principles must be rational.

Florida Administrative Code rule 25-14.004 contains the requirements associated with the Commission's parent company debt rule. This rule requires the tax expense associated with the debt component of the parent's capital structure (allegedly representing the parent's investment in the subsidiary) to be used to reduce the tax expense of the regulated company. Section (3) of the rule states:

> The capital structure of the parent used to make the adjustment shall include at least long term debt,

> short term debt, common stock, cost free capital and investment tax credits, excluding retained earnings of the subsidiaries. It shall be a rebuttable presumption that a parent's investment in any subsidiary or in its own operations shall be considered to have been made in the same ratios as exist in the parents overall capital structure.

(emphasis added).

The utilization of the capital structure should be identical for both the equity removal of GTECC and the application of the parent company debt rule. The order does not state any reason for there to be a difference between the two applications. The Commission should use all components of the capital structure when making the GTECC removal to be consistent with its parent company debt rule.

The Commission's pro rata approach associated with the parent company debt rule is supported by case law. The 100% removal of GTECC from equity is not. In State of N. C. ex rel. Utilities Comm'n v. Pub. Staff-North Carolina Util. Comm'n, 332 N.C. 689, 370 S.E. 567 (1988), the Attorney General argued that the North Carolina Commission had erred in failing to remove the utility's non-utility investment 100% from Duke Power Company's equity capital structure for ratemaking purposes. The North Carolina Commission had used a pro rata removal. The North Carolina Supreme Court rejected the contention that non-utility investment should be removed 100% from the equity component:

> The flaw in the Attorney General's argument ...is that it assumes that when Duke invests in a subsidiary company (the non-utility

> investment) the invested proceeds are derived wholly from capital accumulated by the sale of common equity. As we have noted earlier, capital is derived from the sale not only of common equity but from the sale of preferred stock and bonds. When proceeds from capital accumulated from all three sources is invested elsewhere, the assumption must be that these proceeds are derived from each source of capital in the same ratio as each source bears to the other on Duke's books. Thus if any reduction in Duke's capital structure is to be made for rate-making purposes because of Duke's investment of some of its capital in non-regulated companies, the reduction must be made in each source of capital according to the ratio each source bears to the other.

370 S.E.2d at 576.

Thus, the Commission's 100% removal of GTECC from equity is improper. The Commission understands the concept of how funds flow through a capital structure and it does it correctly for purposes of the parent company debt rule. The same approach should apply to the GTECC removal.

3. REMOVAL OF NONREGULATED INVESTMENT FROM GTEFL'S CAPITAL STRUCTURE SHOULD BE CONSISTENT WITH THE PRO RATA METHOD APPLIED IN UNITED'S RATE PROCEEDING.

The Commission's decision to remove 100% of GTEFL's nonregulated investment in GTECC from 100% equity rather than pro rata from the entire capital structure is also contrary to the resolution of an identical issue in a recent United Telephone of Florida rate proceeding. In re: Application for a Rate Increase by United Tel. Co. of Fla., 92 F.P.S.C. 7:555 (1992). This inconsistency renders the Commission's decision arbitrary and capricious. In United's rate proceeding, the full Commission lowered United's authorized return on equity to 12.5% from a requested level of 13.95% finding

that this return was analogous to that of comparably risky companies. The Commission further determined that the authorized equity ratio of 57.5% for United was within the range of equity ratios of companies having comparable credit ratings. United, supra, 92 F.P.S.C. 7 at 599. Based on these findings, the Commission concluded that only the cost of regulated telephone service was being included in the revenue requirement and that United's nonregulated investments should be removed from the capital structure on a pro rata basis. Id. at 602.

The Commission's reasoning in the United case should be applied to how GTECC is removed from GTEFL's capital structure. As in the United decision, the Commission reduced GTEFL's proposed return on equity of 13.6% to 12.2%, a return which is below the returns afforded companies of comparable risk, not to mention United. In addition, GTEFL's proposed 58.25% equity ratio is well within the range of equity ratios of companies with comparable credit ratings. (Tr. 678).

Given that GTEFL's authorized return on equity and proposed equity ratio received the same basic treatment as United, the Commission was assured that ratepayers were not financing nonregulated activities either through excess equity or a higher return on equity. Again, as in previous adjustments addressed in this brief, the Commission had before it a situation that was identical to established precedent and failed to follow that precedent without any explanation. This action violates this Court's decision in Southern Bell Tel. and Tel. Co. v. Fla. Pub. Serv.

Comm'n, 443 So. 2d 92, 96 (Fla. 1983), which held that while the Commission has significant discretion, it cannot be implemented in an arbitrary and capricious manner. The Court stated:

> This discretionary authority may not be implemented in an arbitrary or haphazard manner that would permit the charitable contributions of one utility to be included as an operating expense while denying such treatment to another utility.

443 So. 2d at 96.

The Commission's approach is inconsistent with the pro rata method applied by the Commission in the United case and constitutes an arbitrary and capricious decision. The adjustment should be reversed.

VI. CONCLUSION

This Court has consistently recognized that the Orders of the Public Service Commission must be fair, just and reasonable pursuant to the requirements of the Fifth and Fourteenth Amendments to the United States Constitution and Article I, Section 9 of the Florida Constitution. The Commission has failed to produce this result in GTEFL's 1992 rate case. The Commission's decisions on the issues raised here either ignore the competent and substantial evidence of record or engage in arbitrary and capricious agency action, in departure from essential requirements of law.

GTEFL requests that this Court reverse and remand the orders of the Public Service Commission as they pertain to the issues on appeal with instructions to enter amendatory orders authorizing an additional $18,600,000 in expenses for ratemaking purposes and rate recovery.

Thomas R. Parker
Bar No. 449725
P. O. Box 110, FLTC0007
Tampa, FL 33601
813-228-3087

Attorney for GTE Florida
Incorporated

Dated: September 3, 1993

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true copy of GTE Florida Incorporated's Initial Brief in Case No. 82,003 (FPSC Docket Nos. 920188-TL and 920939-TL) has been hand-delivered this the 3rd day of September, 1993, to the following:

Rob Vandiver
Florida Public Service Commission
101 East Gaines Street
Tallahassee, FL 32399-0873

Jack Shreve
Office of Public Counsel
c/o The Florida Representatives
111 W. Madison Street, Room 801
Tallahassee, FL 32399-1400

Thomas R. Parker