BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Modified minimum filing report of INDIANTOWN TELEPHONE SYSTEM, INC.	DOCKET NO. 900921-TL ORDER NO. PSC-92-0036-FOF-TL ISSUED: 03/10/92

The following Commissioners participated in the disposition of this matter:

THOMAS M. BEARD, Chairman
SUSAN F. CLARK
J. TERRY DEASON
LUIS J. LAUREDO

NOTICE OF PROPOSED AGENCY ACTION
ORDER ADDRESSING INDIANTOWN TELEPHONE
SYSTEM, INC.'S MMFRS, REDUCING ROE AND
EQUITY RATIO, AND ELIMINATING TOUCHTONE CHARGES

BY THE COMMISSION:

NOTICE is hereby given by the Florida Public Service Commission that the action discussed herein is preliminary in nature and will become final unless a person whose interests are adversely affected files a petition for a formal proceeding, pursuant to Rule 25-22.029, Florida Administrative Code.

I. BACKGROUND

Indiantown Telephone System, Inc. (Indiantown or the Company) filed Modified Minimum Filing Requirements (MMFRs) for the twelve months ending December 31, 1990, on March 31, 1991. A staff audit of the MMFR schedules was completed and an audit report was issued on July 29, 1991.

II. FIBER OPTIC PROJECT

During 1990, Indiantown participated in a fiber optic project with Southern Bell Telephone and Telegraph Company (Southern Bell). The project involved sharing a trench with Southern Bell for the installation of a fiber system toll route to connect Indiantown to Southern Bell. Indiantown contracted with Southern Bell for the design and installation of the system. To finance this project, Indiantown borrowed $655,000 from BellSouth Financial Services Corporation (BellSouth). The loan will be paid back over 10 years at an annual interest rate of 12.95%. Indiantown was not required

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to finance the project through BellSouth in order to participate in this project.

According to the audit report, Indiantown's traffic studies indicated the need for a fiber optic route through its service area as early as 1988. The staff auditor stated that the Company had adequate time to arrange more reasonable financing for the project. Among the various sources of financing considered by the Company was a loan from the Rural Telephone Bank (RTB). The Company states that such a loan would carry an interest rate of 9.5% and would be payable over 35 years. The Company asserts that the drawback to this type of loan is that it would have required additional engineering work, which could have increased the project's cost by 10%.

Indiantown agrees that it could also have financed the project with a loan from the Rural Telephone Finance Cooperative (RTFC). However, the Company argues that a loan from the RTFC would have required the creation of a financing/leasing subsidiary that would have created additional costs. We note, however, based on the number of subsidiaries and affiliated companies that already exist within the organization, such costs did not appear to be an impediment in the past.

A third option would have been for Indiantown to pay for the project outright. The Company indicates that it had sufficient funds in temporary investments and cash to pay for the project. Indiantown states that it elected to finance the project through BellSouth, however, because the interest rate was within its cost of equity range of 11.50%-13.50%. We believe this reasoning is flawed, since the Company should recognize the obvious differences between its cost of equity and its cost of debt and should seek the lowest cost source of capital consistent with maintaining an acceptable equity ratio.

We believe that the 12.95% interest rate for financing of the project is higher than was necessary and is not in the best interest of the ratepayers. Generally accepted financial theory holds that the cost of equity should be the highest-cost source of capital. We believe that borrowing at a rate close to or higher than the Company's cost of equity does not demonstrate prudent financial management.

We hereby propose finding that the Company should have financed the project with a loan from the RTB. Based on

Indiantown's amortization schedule for the BellSouth loan, the Company will pay $411,560 in interest over 10 years for the $655,000 it borrowed for the project. Even if Indiantown's contention that it would incur additional costs as a prerequisite for a RTB loan is correct, this cost would have been offset by the interest savings associated with the lower interest rate.

Information from the RTB indicates that the 9.5% rate is the short-term rate for the first year of a loan made in October, 1990. After that first year, the rate decreases to a long-term rate of 5.43% for the remaining period of the loan. 5.43% is the long-term rate the RTB established in September, 1991. We note that the RTB offers financing over periods less than 35 years and that 10 years is an acceptable loan period.

We have recalculated the cost rate for financing the fiber optic project as though it were financed by the RTB. We have allowed for the 10% additional engineering cost and for the purchase of RTB stock. We have assigned a 9.5% cost rate to the average balance for the financing of the fiber optic project in both the 1990 and 1991 capital structures. For 1992, we used the 5.43% rate. Since the project was undertaken in late 1990, the effect of this adjustment in 1990 is minor. In 1990, this adjustment reduces the embedded cost of debt from 8.56% to 8.53%. For 1991, this adjustment reduces the embedded cost of debt from 9.50% to 9.13%. For 1992, this adjustment reduces the embedded cost of debt to 8.72%.

III. 1990 EARNINGS

The results of the audit indicate that the Company did not overearn in 1990. The calculated average achieved return on equity (ROE) for 1990 was 6.86%. This ROE was calculated using Indiantown's financial statements, audit exceptions discussed in the audit report, and the final 1990 Cost Study filed with this Commission on July 2, 1991. The Company's authorized range of ROE is 11.9% to 13.9%, with a midpoint of 12.9%. This was established in Docket No. 891235-TL, by Order No. 23237, issued July 23, 1990.

The Company's most recent Earnings Surveillance Report (ESR) and the MMFRs indicate that the Company's achieved ROE was 4.62% for the year ending December 31, 1990. The contributing factors to the difference between our figures and the Company's are as follows:

A. At the time of filing the MMFRs and the ESR, the 1990 Cost Study had not been completed; thus, Indiantown had used the 1989 separations factors. The final 1990 Cost Study was filed on July 3, 1990, and revenue requirements have been recalculated based on the final 1990 jurisdictional separations factors.

B. The audit report issued on July 29, 1991, disclosed three audit exceptions: legal fees, stockholder's intangible tax, and expense reclassification. A total of $11,250 of non-utility related and unsupported legal expenses shall be removed. A $4,174 intangible tax payment on behalf of the stockholders shall not be allowed for ratemaking purposes. In addition, the Company expensed $4,166 that should have been capitalized. Indiantown's total company expenses shall be reduced by $19,590. Total company plant in service shall be increased by $4,166 and depreciation expense shall be increased by $112.

C. Indiantown did not properly reflect the true-ups for intraLATA private line revenue settlements for 1990 and the prior years. Intrastate revenue shall be reduced by $46,109.

D. Indiantown incurred $33,208 of Contributions in Aid of Construction (CIAC) amortization expense in 1990; however, the Company failed to reflect this in the ESR. CIAC amortization expense is an intrastate expense with a credit balance; therefore, intrastate depreciation and amortization expense shall be reduced by $33,208.

A minor adjustment was made to the depreciation expense due to the Company's failure to use correct average plant balances for certain cable accounts. In addition, non-utility investment was removed directly from equity in reconciling capital structure and rate base. The total of the aforementioned changes will bring the Company's earnings to a 6.86% ROE, which is below its authorized floor of 11.9% in 1990. Accordingly, we find it appropriate to take no further action concerning Indiantown's 1990 earnings.

IV. PROJECTED EARNINGS FOR 1991

Using nine months of 1991 actual data, we have forecasted earnings for 1991 and it appears that Indiantown will not earn above its authorized ROE ceiling. We estimate Indiantown's achieved ROE for 1991 to be 8.81%. A contributing factor to the Company's expected improved earnings in 1991 compared to 1990 is an increase in Universal Service Fund (USF) revenue. In 1991, Indiantown is expected to receive $495,032 in USF revenue, an increase of $209,924 from 1990. Although USF revenue is received from the National Exchange Carrier Association (NECA), it is used to reduce intrastate revenue requirements.

Indiantown's Subscriber Plant Factor (SPF) is phasing down in 1991, which means that an increased amount of rate base and expenses will be assigned to the intrastate jurisdiction, causing intrastate revenue requirements to increase. The SPF phase-down and the weighted Dial Equipment Minute (DEM) transitional factor phase-up will increase the intrastate revenue requirements by $36,576 in 1991.

Incorporating the adjustment addressed in Section I, Indiantown's expected achieved ROE for 1991 is 8.81%. Accordingly, we find it appropriate to take no further action at this time concerning Indiantown's 1991 earnings. We will continue to monitor Indiantown's 1991 earnings through the quarterly ESR and will take appropriate action, if necessary, following our review of those reports.

V. EQUITY RATIO

Based on the forecasted capital structure for 1992, Indiantown's equity ratio is 56.2%. Since equity is typically the highest cost source of capital, a company retaining all its earnings or not using debt as a source of capital will increase its after-tax cost of capital and, therefore, its revenue requirements.

We note that Indiantown has accumulated significant amounts of cash, receivables, and temporary investments. The Company is classifying its temporary investments as non-regulated assets and is lending funds to outside third parties. One reason for this accumulation is that Indiantown does not pay dividends. Based on the maximum dividend payout ratio of 60% set by the RTB, we

estimate that the Company could have paid $2,166,645 in dividends from 1979 through 1992.

Accordingly, we find it appropriate that $1,508,507 in non-utility investment be removed specifically from equity. This amount consists of $566,353 in accounts receivable from an affiliate, $342,124 in notes receivable from an apparently unrelated third party, and $600,030 in preferred stock in an affiliated bank. It is Commission practice to remove non-utility investment from equity because such investment represents higher risk. After this adjustment, Indiantown's equity ratio decreases to 46.25%.

Standard & Poor's (S&P's) most recent equity ratio benchmark for "low risk" BBB-rated telephone companies was 35% to 45%. For "high risk" BBB-rated telephone companies, the benchmark for equity ratios was 38% to 50%. The difference between "low risk" and "high risk" has been based on S&P's evaluation of the effects of competition and state regulation on local exchange companies. We note that as of January 13, 1992, S&P no longer distinguishes between "high risk" and "low risk" and that for BBB-rated telephone companies, the equity ratio guidelines are now 38% to 50%.

We believe that Indiantown's financial management has resulted in high balances of cash and temporary investments and in a relatively high equity ratio for the 1992 projected test year. We believe that the benchmark of 45% is a reasonable equity ratio because it represents the highest percentage in the range of equity ratios for former "low risk" BBB-rated companies and is above the midpoint of the range for former "high risk" companies. Therefore, for ratemaking purposes, we find it appropriate that Indiantown's equity ratio be further adjusted to represent 45% of investor capital. We find that these two adjustments to equity and the resulting 45% equity ratio produce a reasonable capital structure for the projected test year 1992. We wish to emphasize that this decision is being made solely on the basis of the facts and circumstances existing in this particular docket and should not be construed as precedent for making any other equity adjustment to any other company.

VI. RETURN ON EQUITY

The return on equity for a utility is inversely related to its equity ratio. Generally, investors view companies with high

amounts of debt in their capital structures as more risky, and require a higher return on equity for such companies. Through a leverage formula similar to one used for the water and wastewater industry, we have calculated a 12.7% cost of common equity for Indiantown, based upon a 45% equity ratio.

We developed this leverage formula by applying generally accepted financial models to the index of Regional Bell Holding Companies (RBHCs) and the Moody's Natural Gas Distribution index. The results of these models were adjusted to reflect the difference between the AA-rating for the indices and the BBB-rating that was assumed for a small telephone company. We used the most recent information available, which is the data for the month of December, 1991, for the discounted cash flow and risk premium analyses.

We believe the equity ratio and the cost of equity are inherently related. A leverage formula is a relatively quick and simple method of estimating the current cost of equity. Accordingly, we find that the appropriate return on equity for Indiantown is 12.7% ± 1% based on the 45% equity ratio adjustment proposed in Section V.

VII. PROJECTED EARNINGS FOR 1992

Based upon our forecast of 1991 earnings, we have projected Indiantown's 1992 earnings. The foremost factors affecting the 1992 earnings, other than the adjustments discussed in Sections II, V and VI, are as follows:

A. NECA's preliminary estimate of Indiantown's 1992 USF revenue is $619,716, an increase of $124,684 from 1991 USF revenue.

B. Corporate expense shall be reduced by $62,790, intrastate, for the following:

   1. An out-of-period entry of $10,700 for benefits for the former president of Indiantown Telephone shall be removed.

   2. A nonrecurring charge of $55,000 associated with the former president shall be removed.

3. The Company had an office in Long Island, New York, where the former president and the treasurer performed some of the duties. However, the Company decided to close that office in late 1991 and relocate the treasurer to Indiantown, Florida. Approximately $24,000 of travel expenses shall be eliminated in 1992.

Corporate expense shall be reduced by $89,700 total company, $62,790 intrastate.

C. Indiantown is expected to incur an additional $30,000 of engineering costs in 1992 related to a fuel tank contamination issue brought up by the Environmental Protection Agency.

D. As discussed in Section IV, changes in the separations factors due to the SPF and the weighted DEM transitional factor will cause an increase in intrastate revenue requirements of $36,576.

E. A flat rate, two-way, nonoptional calling plan between Indiantown and Stuart was approved on October 15, 1991, in Docket No. 900913-TL, by Order No. 25241, issued October 22, 1991. The annual revenue impact due to this calling plan is a reduction in revenue of $31,795.

We find that incorporating the aforementioned adjustments along with the equity and debt adjustments discussed previously will provide a reasonable forecast for 1992. We estimate the Company's achieved ROE for 1992 to be 13.11%, with earnings of $12,137 above the ROE midpoint of 12.7%.

VIII. DISPOSAL OF REVENUES ABOVE MIDPOINT

In view of Indiantown's projected earnings above the midpoint, we find it appropriate to reduce rates by unbundling the gross receipts tax from existing rates and by eliminating all Touchtone charges. The elimination of Touchtone charges will benefit most of Indiantown's customers and is not opposed by the Company.

Touchtone charges for Indiantown's customers are currently $1.50 for residential customers and $2.50 for businesses. These

rates are among the highest in the state and amount to $33,460 in annual revenues for Indiantown. Combining the revenues in excess of ROE midpoint with revenues from separating out the gross receipts tax should equal $35,888. TouchTone charges shall be eliminated entirely with these revenues. The $2,428 difference will take the Company above its recommended midpoint; thus, this amount shall be applied to local rates. The effect will be a decrease of about $0.06 per access line.

We shall not make any changes to EAS routes, BHMOC, MTS rates, or other areas. Although these too are high priorities when analyzing the disposal of excess income, significant changes to any of the other categories would require far more revenues than are available in this proceeding. The decisions here, we believe, are as the best "fit" between our rate reduction priorities and available revenues.

The Company is scheduled to implement EAS on the Indiantown/Stuart route on April 1, 1992. This will require a change in local rates. Accordingly, the Company shall also make the rate changes ordered here at the same time. The Company shall provide notice of these changes to its customers through appropriate bill stuffers.

IX. CURRENT MMFRS AS MOST RECENT RATE CASE

Section 364.035(3), Florida Statutes, provides:

> It is the legislative intent in requiring the mandatory filing of the minimum filing requirements that the Public Counsel and other substantially affected persons be assured of periodically obtaining the necessary information to reasonably ascertain whether the rates and charges of a local exchange telecommunications company are just, reasonable, not unjustly discriminatory, not in violation of law, and not yielding excessive compensation for the service rendered.

This Section authorizes a less burdensome proceeding than a full rate case, yet still provides us with filings that contain enough information to make a reasoned determination of whether the rates of a company are just and reasonable. Section 364.035(3) mandates local exchange companies with less than 100,000 access lines to file MMFRs every five years. In the past, most of the

small local exchange companies had a formal rate proceeding on an average of once every ten years. The new statute provides all parties an opportunity to address accounting adjustments and an appropriate return on equity on a regularly scheduled basis. Because these periodic reviews offer an opportunity for a full review, we find that this MMFR proceeding shall be treated as the most recent rate case proceeding for Indiantown for all future purposes.

Based on the foregoing, it is

ORDERED by the Florida Public Service Commission that Indiantown Telephone System, Inc. has complied with its Modified Minimum Filing Requirements obligation pursuant to Section 364.035, Florida Statutes. It is further

ORDERED that Indiantown Telephone System, Inc. shall have the cost rate for financing its fiber optic project adjusted in accordance with the decision set forth herein. It is further

ORDERED that Indiantown Telephone System, Inc. has not earned in excess of its maximum authorized return on equity for 1990. It is further

ORDERED that, based upon the analysis contained herein, Indiantown Telephone System, Inc. is not expected to exceed its authorized return on equity for 1991; therefore, no further action is required at this time. It is further

ORDERED that certain non-utility investments be removed specifically from equity as set forth in the body of this Order. It is further

ORDERED that Indiantown Telephone System, Inc.'s equity ratio shall be reduced to 45% of investor-supplied capital for all future regulatory purposes. It is further

ORDERED that the appropriate return on equity for Indiantown Telephone System, Inc. shall be 12.7% ± 1% for all future regulatory purposes. It is further

ORDERED that, based upon its projected earnings for 1992, Indiantown Telephone System, Inc. shall reduce its 1992 revenues in accordance with the directives set forth herein. It is further

ORDERED that Indiantown Telephone System, Inc.'s 1992 projected earnings above the midpoint, as well as revenues produced through unbundling the gross receipts tax, shall be disposed of by eliminating Touchtone charges and reducing local rates as set forth in the body of this Order. It is further

ORDERED that Indiantown Telephone System, Inc. shall file appropriate tariff revisions as soon as practical, to become effective April 1, 1992. It is further

ORDERED that Indiantown Telephone System, Inc. shall notify its customers of the aforementioned rate changes through appropriate bill stuffers. It is further

ORDERED that Indiantown Telephone System, Inc.'s Modified Minimum Filing Requirement proceeding shall be treated as the Company's most recent rate case for all future regulatory purposes. It is further

ORDERED that this Order shall be final and the docket shall be closed if no proper protest is timely filed in accordance with the requirements set forth below.

By ORDER of the Florida Public Service Commission, this 10th day of MARCH, 1992.

STEVE TRIBBLE, Director
Division of Records and Reporting

(S E A L)

by: Kay Flynn
Chief, Bureau of Records

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NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.59(4), Florida Statutes, to notify parties of any administrative hearing or judicial review of Commission orders that

is available under Sections 120.57 or 120.68, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing or judicial review will be granted or result in the relief sought.

The action proposed herein is preliminary in nature and will not become effective or final, except as provided by Rule 25-22.029, Florida Administrative Code. Any person whose substantial interests are affected by the action proposed by this order may file a petition for a formal proceeding, as provided by Rule 25-22.029(4), Florida Administrative Code, in the form provided by Rule 25-22.036(7)(a) and (f), Florida Administrative Code. This petition must be received by the Director, Division of Records and Reporting at his office at 101 East Gaines Street, Tallahassee, Florida 32399-0870, by the close of business on 3/31/92.

In the absence of such a petition, this order shall become effective on the day subsequent to the above date as provided by Rule 25-22.029(6), Florida Administrative Code.

Any objection or protest filed in this docket before the issuance date of this order is considered abandoned unless it satisfies the foregoing conditions and is renewed within the specified protest period.

If this order becomes final and effective on the date described above, any party adversely affected may request judicial review by the Florida Supreme Court in the case of an electric, gas or telephone utility or by the First District Court of Appeal in the case of a water or wastewater utility by filing a notice of appeal with the Director, Division of Records and Reporting and filing a copy of the notice of appeal and the filing fee with the appropriate court. This filing must be completed within thirty (30) days of the effective date of this order, pursuant to Rule 9.110, Florida Rules of Appellate Procedure. The notice of appeal must be in the form specified in Rule 9.900(a), Florida Rules of Appellate Procedure.