FLORIDA PUBLIC SERVICE COMMISSION
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October 23, 1997

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYO)

FROM: DIVISION OF AUDITING & FINANCIAL ANALYSIS (HACKNEY, LEE, MAILHOT)
DIVISION OF COMMUNICATIONS (SIMMONS)
DIVISION OF LEGAL SERVICES (PELLEGRINI)

RE: DOCKET NO. **971396-TL** - NORTHEAST FLORIDA TELEPHONE COMPANY, INC. - INVESTIGATION OF 1996 EARNINGS OF NORTHEAST FLORIDA TELEPHONE COMPANY, INC.

AGENDA: 11/04/97 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\AFA\WP\971396.RCM
R:\PSC\AFA\123\971396.WK4

CASE BACKGROUND

By Order No. PSC-92-0337-AS-TL, issued May 12, 1992, the Commission approved, with certain modifications, a settlement agreement (the Agreement) submitted by Northeast Florida Telephone Company, Inc. (Northeast or the Company) and the Office of Public Counsel. The Agreement required rate reductions and addressed earnings until Northeast's Bill and Keep Subsidy is eliminated. The Agreement provides that to the extent that, subsequent to January 1, 1993, Northeast earns in excess of the 13.20% ceiling established by the Agreement, Northeast will refund such overearnings to the payor of the Bill and Keep Subsidy, BellSouth, and will also eliminate future subsidy receipts by a like amount.

This recommendation presents the recommended disposition of 1996 earnings based on Staff's review of Northeast's final 1996 Earnings Surveillance Report, filed on October 22, 1997.

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DISCUSSION OF ISSUES

ISSUE 1: Did Northeast Florida Telephone Company earn in excess of its maximum stipulated return on equity (ROE) of 13.20% for 1996?

RECOMMENDATION: Yes, Northeast earned $109,190 in excess of 13.20% ROE. (HACKNEY)

STAFF ANALYSIS: Northeast filed its preliminary 1996 Earnings Surveillance Report (ESR) in March 1997, a revised ESR on April 28, 1997, and the final 1996 ESR on October 22, 1997. An audit of Northeast's 1996 earnings was completed by Staff and a report issued on August 7, 1997.

The revised ESR was filed to adjust expenses for the allocation of land and buildings, furniture, and computer expenses between Northeast and its holding company. These adjustments decreased the achieved ROE from 14.59% to 14.44%.

In addition to these adjustments by the Company, Staff has made several adjustments to the original and revised ESRs as a result of our review and audit of Northeast. First, after the National Exchange Carriers Association (NECA) Cost Study was filed on July 30, 1997, Staff revised the factors used in calculating interstate expenses and investment. Because the interstate expense factors increased, the intrastate amounts decreased and the achieved ROE increased.

Another adjustment involved the receipt of a $32,469 cash dividend from the Rural Telephone Bank (RTB) because of the retirement of two RTB loans by Northeast. The Company recorded this in a nonoperating income account. For ESR purposes this amount should be treated as a reduction to interest expense. The effect of the adjustment made by Staff was that the cost of debt was reduced and the achieved ROE increased.

The final adjustment made by Staff involved the $14,221 in expense the Company incurred in producing a Cost Allocation Manual (CAM). The CAM addresses how joint costs should be allocated between regulated and nonregulated operations. In the last six months of 1996, the amount charged, both directly and through the CAM, to nonregulated operations was $89,723. In the first three months in 1997, this amount was $51,382, therefore the amounts involved are increasing. Because the CAM relates to the allocation of investment and expenses between regulated and nonregulated operations, a portion of the costs of creating the CAM should also be allocated to nonregulated operations. In the original ESR, the Company failed to do this. The amount of the adjustment, using the allocation method outlined in the CAM, is a $212 reduction to Corporate Operations Expense. Staff did not conduct a thorough review of the CAM for 1996. However, Staff may in the future review the actual cost allocation methodologies established by the CAM to determine if the allocations are reasonable.

On October 22, 1997, Northeast filed its final ESR incorporating Staff audit findings and the revised cost study filed with NECA. Based on Staff's review and modification of the final ESR, Northeast's earnings above the maximum allowable ROE of 13.20%, for 1996 are $109,190, as shown on Attachment A.

<u>ISSUE 2</u>: Should the Commission approve Northeast's request to write off the reserve deficiency associated with the Blackwell and Sanderson RLS-4000 Remote Line Switching equipment in 1997?

<u>RECOMMENDATION</u>: Yes. Staff recommends that the Commission approve Northeast's request to recover, during 1997, the existing negative reserve of $289,334 associated with the 1996 retirement of the Blackwell and Sanderson remote switches. (LEE)

<u>STAFF ANALYSIS</u>: The switching network plan of Northeast in 1994 was to move from the existing Stromberg-Carlson DCO (Digital Central Office) switching platform to the new Electronic Switching System-Digital (EWSD) Vision ONE-UP Platform (Vision ONE) in Macclenny in 1995. The Vision ONE upgrade required the retirement of the DCO processor and associated circuit equipment and the installation of the EWSD. The DCO lines would then be incorporated into the EWSD. Additionally, Siemens Stromberg-Carlson told Northeast that the existing Remote Line Switching (RLS-4000 and 1000) equipment located in Blackwell, Sanderson, Connor, and Mudlake would also interface with the EWSD. The Vision ONE upgrade would allow Northeast the ability to offer services such as ISDN and to add Advanced Intelligent Network (AIN) and Personal Communications Services (PCS) for an additional price. By Order No. PSC-95-0426-FOF-TL, issued March 29, 1995 in Docket No. 910731-TL, the Commission found that the Vision ONE platform would introduce potential revenue sources that did not currently have a market demand and provide an advanced infrastructure which could potentially provide an economic boost for the Northeast service area. Further, the upgrade was a logical progression of Northeast's switching hierarchy, and therefore a reasonable investment.

During 1996, Northeast installed an RLS-4000 switch at Glen St. Mary and the EWSD switch in the Macclenny host office. At the time the installation of the Glen St. Mary RLS-4000 was nearing completion, Northeast learned that this new switch, as well as the existing RLS-4000 equipment at Blackwell and Sanderson, would not integrate with the new Vision ONE upgrade as it had originally been informed by Siemens Stromberg-Carlson. Further, Northeast learned that Siemens would no longer offer support for the RLS-4000s due to the protocol problems. The only remote switching equipment that was compatible with the Vision ONE upgrade was Remote Control Unit (RCU) equipment and RLS-1000 equipment. Consequently, in order for service to continue to be provided to the Blackwell and Sanderson areas, Northeast had to replace the existing RLS-4000 equipment with RCU equipment. Siemens replaced the Glen St. Mary RLS-4000 with an RCU at no additional charge.

The Mudlake and Connor remote offices are RLS-1000s and can interface with the new software. However, the new services provided by the EWSD cannot be provided through these remotes unless they are replaced. Current planning is that this replacement will take place in the 1997-1998 time frame. Once these remotes are converted to RCUs, Northeast will retire the DCO switch as it will no longer be needed.

As of December 31, 1996, the net unrecovered costs associated with the RLS-4000 remotes at Blackwell and Sanderson were $289,334, total company. The net amount recognizes $235,708 in compensation from Siemens. By letter, Northeast has proposed that the 1996 overearnings be applied to the recovery of this net amount with the residual to be written off in 1997. Staff supports this requested action since it corrects the resultant reserve deficiency. The existence of a negative reserve relates to plant no longer serving the public on which the company continues to earn as long as it exists. Staff believes that deficiencies such as this should be recovered as soon as possible, unless that recovery prevents the company from earning a fair and reasonable return on its investments. Northeast projects that it will have sufficient earnings in 1997 to absorb this recovery and still earn within its authorized range. Staff therefore recommends that the Company be allowed to recover the remaining unrecovered costs associated with the 1996 retirement of the Blackwell and Sanderson remote switches in 1997. Additionally, when planning becomes more firm regarding the replacement of the Mudlake and Connor RLS-1000s, Northeast should request a recovery schedule for the associated unrecovered costs.

ISSUE 3: What is the appropriate disposition of the amounts identified in Issue 1?

RECOMMENDATION: $112,203 consisting of the $109,190 in intrastate revenue identified in Issue 1 plus $3,013 in interest accrued through December 31, 1996, should be applied to the reserve deficits discussed in Issue 2, effective December 31, 1996. (HACKNEY)

STAFF ANALYSIS: Issue 1 identifies intrastate revenues of $109,190 in excess of the 13.20% ROE.

On March 10, 1997, Northeast requested that it be allowed to apply any 1996 overearnings against the depreciation reserve deficits resulting from the unexpected early retirement of the RLS-4000 units in the Blackwell and Sanderson offices. In addition, for any remaining deficit after the overearnings are applied, the Company has requested that this be fully recovered through a "depreciation writeoff" in 1997. In Issue 2, Staff recommends that the proposed "depreciation writeoff" be approved. The total company amount of the reserve deficit is $289,334. The intrastate amount of overearnings is $112,203, including interest. This amount on a total company basis is approximately $160,313. After applying 1996's overearnings to the reserve deficits, there is approximately $129,021 to recover. Part of the $129,021 will be recovered by the additional depreciation expense proposed by Northeast in Issue 4. The remaining amount will be recovered in 1997's earnings.

The Agreement provides that to the extent that subsequent to January 1, 1993, Northeast earns in excess of the 13.20% ceiling established by the Agreement, Northeast will refund such overearnings to the payor of the Bill and Keep Subsidy, which is BellSouth, and will also eliminate future subsidy receipts by a like amount. In this case, Staff recommends that $112,203 (approximately $160,313 total company) consisting of the $109,190 in intrastate revenue identified in Issue 1 plus $3,013 in interest accrued through December 31, 1996, be used to write off part of the depreciation deficit resulting from the early retirement of the RLS-4000 units at the Blackwell and Sanderson offices. BellSouth is agreeable to this disposition.

ISSUE 4: Should the Commission accept Northeast's proposal to record additional depreciation expense applicable to 1996?

RECOMMENDATION: Yes. The Commission should accept Northeast's proposal to record an additional $15,000 (intrastate) in depreciation expense applicable to 1996, in order to resolve all the issues related to 1996's earnings. (MAILHOT)

STAFF ANALYSIS: Northeast proposes to record an additional $15,000 (intrastate) in depreciation expense applicable to 1996. This will result in approximately $21,428 in additional total company depreciation expense. This amount will be applied to the negative reserve discussed in Issue 2. Staff believes this is a reasonable proposal because it helps to recover the reserve deficit more quickly without having a serious adverse impact on the Company's earnings. This will also further reduce the intraLATA subsidy and result in the elimination of the subsidy on a prospective basis, as discussed in Issue 5.

ISSUE 5: Should the Commission approve the elimination of Northeast's IntraLATA Bill and Keep Subsidy receipts as shown on Attachment C?

RECOMMENDATION: Yes. Northeast's intraLATA subsidy receipts should be eliminated, effective January 1, 1998, and Northeast should be removed from the subsidy pool. The intraLATA subsidy pool receipts and payments shown on Attachment C should be approved, effective January 1, 1998. (MAILHOT)

STAFF ANALYSIS: On January 1, 1988, the intraLATA LEC toll bill and keep subsidy pool was established in Docket No. 850310-TL, Implementation of Local Exchange Company Toll Bill and Keep, with all LECs except GTE and Vista-United participating. GTE and Vista-United, which experienced net losses from the implementation of LEC toll bill and keep, elected not to receive subsidies and do not participate in the pool. Pursuant to Order No. 21597, ALLTEL, Centel, Florala, Gulf, Quincy, and United were allowed to withdraw from the intraLATA subsidy pool. Pursuant to Order No. 21955, Indiantown was removed from the intraLATA subsidy pool due to its excess earnings. St. Joe's subsidy was reduced and then eliminated by Order Nos. 22418 and 22994, respectively. In Order No. PSC-95-0426-FOF-TL, Northeast's subsidy was reduced from $282,000 to $124,000 effective July 1, 1995.

The subsidy pool was established as a temporary mechanism to ease the transition from a pooling environment to a pure bill and keep environment. The subsidy amounts were phased down on January 1st of 1989, 1990, and 1991. Through that phase down mechanism, many of the LECs were able to transition out of the intraLATA bill and keep subsidy pool. The current status of the intraLATA subsidy pool is shown in Attachment B.

Staff recommends that Northeast's intraLATA subsidy receipts be reduced by the $109,000 identified in Issue 1, on January 1, 1998 in accordance with the Agreement. In Issue 4, Staff recommends acceptance of Northeast's proposal to record an additional $15,000 (intrastate) in depreciation expense applicable to 1996, in order to resolve all the issues related to 1996's earnings. Northeast's subsidy is currently $124,000 annually. Reducing the subsidy by $109,000 plus $15,000, results in the elimination of Northeast's intraLATA subsidy. The intraLATA subsidy pool receipts and payments shown on Attachment C should be approved, effective January 1, 1998.

<u>ISSUE 6</u>: Should this docket be closed?

<u>RECOMMENDATION</u>: Yes. If no person whose substantial interests are affected by the Commission's proposed agency action timely files a protest within 21 days of the issuance of the order, this docket should be closed. (PELLEGRINI)

<u>STAFF ANALYSIS</u>: Pursuant to Rule 25-22.029(4), Florida Administrative Code, any person whose substantial interests are affected by the Commission's proposed agency action shall have 21 days after issuance of the order to file a protest. If no timely protest is filed, the docket should be closed.

ATTACHMENT A

NORTHEAST FLORIDA TELEPHONE COMPANY, INC.

CALCULATION OF 1996 OVEREARNINGS

NET OPERATING INCOME PER ESR		$708,183
Staff Adjustment:		
Portion of CAM costs to nonregulated operations	101	
Total Adjustments		101
Adjusted NOI		$708,284
RATE BASE PER ESR		$8,155,170
ROR @ 13.20% ROE	x	7.85%
Maximum allowed NOI		640,181
Achieved NOI		708,284
Excess NOI		68,103
NOI Multiplier	x	1.6033
TOTAL 1996 OVEREARNINGS		$109,190

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ATTACHMENT B

INTRALATA TOLL BILL AND KEEP
CALCULATION OF SUBSIDY PAYMENTS
July 1, 1995
($000)

	1	2	3	4	5	6
COMPANY	INTRALATA BILL/KEEP IMPACT	PREVIOUS PHASE DOWN OF SUBSIDY	PREVIOUS COMM ACTION	TOTAL IMPACT (1+2+3)	SUBSIDY CONTRIB	SUBSIDY RECEIPTS
NORTHEAST	(322)	40	158 *	(124)		(124)
FRONTIER	(151)	23		(128)		(128)
BELLSOUTH	10,099				252	
TOTAL					$252	($252)

* NORTHEAST INCLUDES THE $158,000 REDUCTION APPROVED IN DOCKET 910731-TL.

ATTACHMENT C

INTRALATA TOLL BILL AND KEEP
CALCULATION OF SUBSIDY PAYMENTS
January 1, 1998
($000)

	1	2	3	4	5	6
COMPANY	INTRALATA BILL/KEEP IMPACT	PREVIOUS PHASE DOWN OF SUBSIDY	PREVIOUS COMM ACTION	TOTAL IMPACT (1+2+3)	SUBSIDY CONTRIB	SUBSIDY RECEIPTS
FRONTIER	(151)	23		(128)		(128)
BELLSOUTH	10,099				128	
TOTAL					$128	($128)