

## BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition of the Citizens of the )	DOCKET NO. 890190-TL
State of Florida to investigate SOUTHERN )	
BELL TELEPHONE AND TELEGRAPH COMPANY's )	ORDER NO. 24366
cost allocation procedures )	
_____ )	ISSUED: 04/15/91

Pursuant to Notice, a Prehearing Conference was held on April 9, 1991, in Tallahassee, Florida, before Commissioner Gerald L. Gunter, as Prehearing Officer.

## APPEARANCES:

E. BARLOW KEENER, Esquire, c/o Marshall M. Criser, 150 So. Monroe Street, Suite 400, Tallahassee, Florida 32301, TIMOTHY F. COEN, Esquire, 4300 Southern Bell Center, 675 W. Peachtree Street, NE, Atlanta, Georgia 30375, and JOHN P. FONS, Esquire, Ausley, McMullen, McGehee, Carothers & Proctor, 227 S. Calhoun Street, Tallahassee, Florida 32302, on behalf of SOUTHERN BELL TELEPHONE AND TELEGRAPH COMPANY.

CHARLES J. BECK, Esquire, Office of Public Counsel, c/o The Florida Legislature, 111 West Madison Street, Room 812, Tallahassee, Florida 32399-1400, on behalf of THE CITIZENS OF THE STATE OF FLORIDA.

BRUCE W. RENARD, Esquire, Messer, Vickers, Caparello, Madsen & Lewis, P.A., Post Office Box 1876, Tallahassee, Florida 32302-1876, on behalf of THE FLORIDA PAY TELEPHONE ASSOCIATION and FLORIDA CABLE TELEVISION ASSOCIATION.

RICHARD D. MELSON, Esquire, Post Office Box 6526, Tallahassee, Florida 32314, on behalf of MCI TELECOMMUNICATIONS CORPORATION.

LAURA GILMORE, Esquire, Messer, Vickers, Caparello, Madsen & Lewis, P.A., Post Office Box 1876, Tallahassee, Florida 32302-1876, on behalf of US SPRINT COMMUNICATIONS LIMITED PARTNERSHIP.

ANGELA B. GREEN and TRACY HATCH, Esquires, Florida Public Service Commission, 101 E. Gaines Street, Tallahassee, Florida 32399-0863, on behalf of the COMMISSION STAFF.

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PRENTICE P. PRUITT, Esquire, Florida Public Service Commission, 101 E. Gaines Street, Tallahassee, Florida 32399-0862, on behalf of the COMMISSIONERS.

PREHEARING ORDER

I. BACKGROUND

On November 18, 1988, the Office of Public Counsel (OPC) filed a Petition to Investigate Southern Bell Telephone and Telegraph Company's (Southern Bell's) Cost Allocation Procedures (Petition). Southern Bell moved to dismiss OPC's Petition. By Order No. 20735, issued February 14, 1989, we recognized Southern Bell's authority to provide customer premises equipment (CPE) on a nonstructural basis without obtaining a waiver of Rule 25-4.0345, Florida Administrative Code. However, as we expressly stated in that Order, this recognition was not to be construed as unconditional approval of Southern Bell's use of BellSouth's cost allocation procedures in its nonstructural provision of CPE.

OPC urged through the Petition that we initiate an investigation into Southern Bell's cost allocation procedures and that we set the matter for a hearing. The Petition demonstrated strong reservations regarding whether Southern Bell's cost allocation procedures adequately guard against cross-subsidization of its unregulated operations.

In response and in support of its motion to dismiss, Southern Bell argued that such an investigation was unwarranted, given the scrutiny applied to the cost allocation manual (CAM) in proceedings before the Federal Communications Commission (FCC). Additionally, Southern Bell pointed to routine Staff audits of its own internal and external audits as a further means of assurance against cross-subsidization.

By Order No. 20948, issued March 27, 1989, we granted OPC's Petition. In that Order we noted, as Southern Bell itself conceded, that the FCC's conditional approval of the BellSouth CAM was in no way binding upon this Commission. We noted, as well, that many of the concerns expressed by OPC paralleled those raised by our Staff. Finally, we stated our view that while audits can assure us that cost allocation procedures are being followed,

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audits alone would not disclose the adequacy of the procedures themselves in preventing cross-subsidization. For those reasons, we initiated this proceeding.

## II. TESTIMONY AND EXHIBITS

Upon insertion of a witness's testimony, exhibits appended thereto may be marked for identification. After opportunity for opposing parties to object and cross-examine, the document may be moved into the record. All other exhibits will be similarly identified and entered at the appropriate time during the hearing. Exhibits shall be moved into the record by exhibit number at the conclusion of a witness's testimony.

Witnesses are reminded that on cross-examination, responses to questions calling for a yes or no answer shall be answered yes or no first, after which the witness may explain the answer. Each witness is scheduled for a single appearance during which both direct and rebuttal testimony, if any, shall be offered. Witnesses are reminded that they remain subject to recall following their scheduled appearance.

## III. ORDER OF WITNESSES

<u>Witness</u>	<u>Appearing For</u>	<u>Date</u>	<u>Issues</u>
Thomas F. Lohman	So. Bell	5/1	1, 2, 3, 4, 6, 9, 10
Harold A. Paisant	So. Bell	5/1	2, 3, 5, 6, 7, 8
Richard P. Klein	So. Bell	5/1	1, 2, 3, 9
Kim Dismukes	OPC	5/2	All Issues

OPC has subpoenaed Mr. Rick Wright of the Florida Public Service Commission Staff. OPC intends to question Mr. Wright regarding the September, 1990, Report on BellSouth Corporation and Affiliates prepared by the SEARUC Southern Task Force, as well as the audit conducted by Mr. Wright and the task force. Additionally, OPC announced during the Prehearing Conference that he intends to procure subpoenas for Mr. Jim Hord of the Public

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Staff of the North Carolina Utilities Commission and Mr. Timothy Devlin of the Florida Public Service Commission Staff. Subpeenaed witnesses shall testify following the witnesses listed above.

Finally, Staff indicated that it was in the process of completing a supplemental audit of Southern Bell and may call Ruth Young of the Florida Public Service Commission Staff as a witness.

#### IV. BASIC POSITIONS

SOUTHERN BELL: This proceeding was instituted to investigate whether Southern Bell's cost allocation methodology and procedures adequately guard against cross-subsidization of its nonregulated operations. As the Commission itself noted in Order No. 20948, the purpose of this docket is limited to an investigation into Southern Bell's cost allocation procedures. Order No. 20948 held:

...while audits can assure us that cost allocation procedures are being followed, audits will not disclose the adequacy of the procedures themselves in preventing cross-subsidization. The investigation requested by Public Counsel's petition is an ideal vehicle for addressing our concerns over Southern Bell's cost allocation methodology.

As such, this proceeding is not intended to be an open-ended investigation of every aspect of Southern Bell's regulated and nonregulated operations or each of its affiliate transactions. While Southern Bell does not object to a review of these matters, they are more properly and practically left to the performance of audits pursuant to this Commission's rules or as required by the Joint Cost Order. This proceeding, rather, is a limited proceeding to test the adequacy of the cost allocation methodology and procedures themselves.

The BellSouth Cost Allocation Manual ("CAM") provides guidelines which allow for the proper identification and allocation of costs between regulated and nonregulated operations. The CAM was developed as a result of the Federal Communication Commission's ("FCC") Joint Cost Order which involved an extensive examination of various cost allocation methodologies in which state regulators, consumer advocates, interexchange carriers, local exchange companies ("LECs"), various trade associations and other interested



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parties participated. Both this Commission and the Office of Public Counsel ("Public Counsel") participated in the docket. The final result was the adoption of a "fully distributed costs" methodology. Not all the parties, including BellSouth Corporation, were completely satisfied with the final result. For example, BellSouth was, and is, concerned that the fully distributed cost approach to cost allocation would unnecessarily and inappropriately burden nonregulated operations. Nevertheless, BellSouth has implemented the CAM as approved by the FCC.

By incorporating normal time reporting requirements, such as job function codes and voucher coding, Southern Bell uses traditional management and financial controls to comply with the CAM. These controls include departmental reviews, employee training, internal audits, and external audits. Proper allocation of costs is also ensured by periodic reviews of existing services, reviews of direct time reporting, and reviews of CAM compliance. As such, the CAM not only provides a reasonable and supportable method of identifying costs based on cost causation and assigning such costs to the proper regulated or nonregulated accounts, but also is susceptible to audits and other appropriate mechanism whereby the Commission can assure itself of Southern Bell's compliance with the CAM. Moreover, because the CAM is based on pre-existing Part 32 accounting procedures, it requires very little additional costs to implement. Costs which are associated with the annual external audit review area allocated to nonregulated operations, and costs associated with the recombination of Southern Bell Advanced Systems, Inc. were allocated in accord with the CAM guidelines.

As a result of the CAM's method of excessively distributing costs to nonregulated operations in favor of regulated operations, and for the other reasons stated below, Southern Bell believes that it would be unreasonable and inappropriate to require nonregulated services to provide additional compensation to regulated operations for use of alleged intangible benefits. For instance, to the extent intangible benefits exist, these benefits could flow from nonregulated operations to regulated operations. In addition, nonregulated operations do not use any intangible assets of Southern Bell's which are in Southern Bell's regulated rate base for ratemaking purposes.

The CAM also provides guidelines for transactions between Southern Bell and its nonregulated affiliates. The basis for this

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accounting treatment is found in Section 32.27 of the Uniform System of Accounts ("USOA"). These guidelines require, for instance, in the case of asset transfers, that if there is no tariffed rate or market price available, assets transferred from Southern Bell to a nonregulated affiliate be valued at the higher of net book cost or fair market value. On the other hand, if the asset is transferred from the nonregulated affiliate to Southern Bell, the guidelines require that the charge be at the lower of net book cost or fair market value. Thus, the asset transfer rules not only protect against cross-subsidization, but actually favor regulated operations.

On March 4, 1991, BellSouth Corporation announced a major streamlining of its corporate structure, effective March 1, 1991. This corporate restructuring will not have any impact on the principles underlying in the CAM. The same rules with respect to dealings between regulated and nonregulated affiliates and the allocation of costs between regulated and nonregulated operations are applicable to the new structure. However, where necessary, when the new corporate structure is fully implemented, the CAM will be updated in accord with procedures that have been in place since 1987. The updates of the CAM are filed with the FCC and distributed to the Florida Public Service Commission Staff and Public Counsel and are open for public comment.

OPC'S BASIC POSITION: There is a tremendous incentive for BellSouth to overallocate costs to its regulated operation. Likewise, there is an incentive for BellSouth's unregulated subsidiaries to overcharge for services rendered to Southern Bell. It is thus extremely important that the Commission closely monitor the company's affiliated transactions on a regular basis.

An excessive amount of BellSouth corporate service costs are assigned to regulated operations, caused in part by the use of a general allocator largely driven by the relative sizes of the affiliated companies. It allocates the bulk of unattributable costs to Southern Bell and South Central Bell. A better alternative would be to use a factor which gives some percentage weight to an equal distribution of costs to the three receiving entities: Southern Bell, South Central Bell, and BellSouth Enterprises.

Both BellSouth Services and BellCore use an excessive return on equity when allocating costs to the regulated companies.

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BellCore research project costs should not be expensed by the regulated companies in the year incurred. Instead, the cost should be deferred until after the project is completed and it is feasible to determine where, and over what time period, the benefits from the project will flow.

Costs are not reasonably allocated between the regulated and unregulated operations of Southern Bell. This is particularly evident for certain accounts, such as general marketing support, sales, product advertising, executive, planning, external relations, and legal. In addition, the company has not properly accounted for the costs associated with the recombination of its unregulated CPE operations into the regulated company.

To help alleviate the problem of regulated operations subsidizing unregulated operations, a compensatory fee arrangement should be used to compensate regulated operations for the intangible benefits flowing to unregulated operations. The intangible benefits are not captured in the allocation process.

FPTA'S & FCTA'S BASIC POSITION: Southern Bell Telephone and Telegraph Company's ("Southern Bell") Cost Allocation Manual is an inadequate and insufficient substitution for the protections offered by full structural separation of LEC competitive services from monopoly operations. To the extent that a non-structural process must be used to differentiate between regulated and unregulated services, revisions to the current Cost Allocation Manual ("CAM") filed by Southern Bell and approved by the Federal Communications Commission will be necessary in order to make the CAM's cost methods more accurate and readily verifiable for intrastate purposes. At a minimum, the CAM methods must be revised to assign true economic costs to the nonregulated services. Additionally, CAM methods must not overallocate costs to regulated customers and/or underallocate the benefits of integration, if any, to customers of regulated services. Finally, the methods must be revised to properly account for nonbook transfers of valuable information and resources between competitive and monopoly services.

MCI'S BASIC POSITION: A properly designed and implemented cost allocation manual is a necessary tool to monitor for cross-subsidization when regulated and nonregulated businesses are conducted without complete structural separation. MCI does not

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take a position on the adequacy of Southern Bell's cost allocation manual.

US SPRINT'S BASIC POSITION: Southern Bell Telephone and Telegraph Company's ("Southern Bell") Cost Allocation Manual should be revised to prevent the transfer of tangible and intangible benefits from regulated to unregulated services.

STAFF'S BASIC POSITION: Cost allocation procedures, properly developed and implemented, can be a suitable means to ensure proper distribution of costs between regulated and nonregulated operations, if such procedures are consistently applied and appropriately updated.

V. ISSUES AND POSITIONS:

ISSUE 1: Is a cost allocation manual an appropriate and effective way to prevent cross-subsidization between regulated and nonregulated businesses?

POSITION OF PARTIES:

SOUTHERN BELL: Yes. The CAM establishes a reasonable and supportable basis on which to determine the proper identification and allocation of regulated and nonregulated costs, and compliance with the CAM prevents cross-subsidization of nonregulated operations by regulated operations. The CAM divides all expense and asset accounts into homogeneous cost pools based on their function, i.e., the reason for the expense or asset. After the cost pools are identified, they are analyzed to determine the appropriate allocation criteria for the function being performed. The allocation criteria include direct assignment, direct attribution, indirect attribution and unattributable. The function performed determines which allocation criterion is most appropriate.

Direct assignment is the most specific criterion and is used for functions that are readily identifiable as either regulated or nonregulated. As a function becomes less readily separated between regulated and nonregulated operations, a less direct allocation criterion is used. However, to the greatest extent possible, the most direct measure of cost causation is used, and the vast majority of costs are assigned using direct assignment or direct or indirect attribution of costs. Only a minor amount of costs are



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allocated by using a general allocator. In fact, of the expenses identified to nonregulated activities in Florida for 1989, approximately 66% were directly assigned, 29% were attributed and less than 5% were the result of the general allocator. Thus, the CAM ensures that costs associated with regulated operations and nonregulated operations are appropriately allocated and prevents cross-subsidization between regulated and nonregulated businesses.

OPC: The cost allocation manual and procedures use by Southern Bell do not appropriately and effectively prevent cross-subsidization between its regulated and unregulated businesses. Specific points are covered in more detail in the positions responding to other issues in this docket.

Separate subsidiaries would help prevent some of the cross-subsidization difficulties which exist with the procedures used by Southern Bell. The use of separate subsidiaries would make it easier to discern cross-subsidization; would allow Southern Bell to dispose of its complex cost allocation, accounting, and training systems used to distribute cost between regulated and unregulated operations; and could force Southern Bell to make better decisions concerning the economic viability of its unregulated operations.

A report prepared by the District of Columbia Public Service Commission presented the following points in favor of separate subsidiaries:

- (1) Separate subsidiaries make it easier to detect any cross-subsidization which might occur through procurement practices,
- (2) There is no evidence that separate subsidiaries are more costly than the use of cost allocation methods,
- (3) Separate subsidiaries protect the monopoly ratepayers from losses associated with the risk of failure,
- (4) Separate subsidiaries facilitate the monitoring of intercorporate transactions,

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- (5) Separate subsidiaries eliminate the need to develop accounting rules which prohibit the transfer of costs to ratepayers, and
- (6) Separate subsidiaries protect the general public from anticompetitive activities.

(Dismukes, Hord,  
Wright, Devlin).

FPTA & FCTA: Retention of the current federal cable-telco cross ownership restrictions are necessary to prevent anti-competitive abuse in the provision of video programming service by telephone companies. To the extent that telephone companies are permitted to engage in video programming, such activities must be conducted via the full structural separation requirements of Florida Statutes section 364.338(5). Full structural separation is the only effective means of deterring and minimizing cross subsidization between LEC regulated and nonregulated businesses. If full structural separation is not obtainable for a given LEC competitive service, then only the adoption of an embedded, fully-distributed cost approach for LEC competitive services, along with other competitive safeguards, can minimally simulate the protections afforded via full structural separation. At a minimum, the CAM methods must be revised to assign fully embedded costs to the nonregulated services. Additionally, CAM methods must not overallocate costs to regulated customers and/or underallocate the benefits of integration, if any, to customers of regulated services. Finally, the methods must be revised to properly account for nonbook transfers of valuable information and resources between competitive and monopoly services.

MCI: A properly designed and implemented cost allocation manual is an appropriate tool to monitor and attempt to identify potential cross-subsidization, but a cost allocation manual by itself may not be effective to prevent cross-subsidization.

US SPRINT: US Sprint has no position on this issue at this time.

STAFF: Staff believes that a cost allocation manual, properly developed and implemented, may be an appropriate vehicle to ensure a fair and equitable distribution of costs between regulated and nonregulated operations.

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ISSUE 2: Are there adequate controls in place to ensure accurate and complete time reporting?

POSITION OF THE PARTIES:

SOUTHERN BELL: Yes. Because the CAM is an extension of Part 32 accounting procedures, Southern Bell's traditional accounting procedures continue to apply. As before, these procedures ensure accurate and complete time reporting. In addition, by incorporating normal time reporting requirements, job function codes and voucher coding to identify charges to accounts and cost pools, Southern Bell can utilize the management and financial controls traditionally used to ensure accounting accuracy. These controls include departmental reviews, employee training, internal audits, management reviews and audits by external auditors. The application of these controls ensures that allocation factors are appropriately developed and charges are accurately reported.

Moreover, allocation factors for existing services are periodically reviewed to ensure that they are appropriate and representative of work functions. Although certain controls can monitor CAM compliance, the most effective method of control is adequate training of direct reporting employees. Southern Bell has in place extensive training which has been conducted for direct time reporting employees.

OPC: No. An audit of noncontact sales in Florida conducted in December, 1990, for example, provides a number of specific criticisms. So, too, does another audit of the time reporting practices of employees who were previously with Advanced System, Inc. And so does an audit conducted in December, 1989. These findings are discussed in detail at pages 41 through 43 of Ms. Dismukes' unredacted testimony. (Dismukes).

FPTA & FCTA: FPTA and FCTA have seen no indication that reliable and verifiable records exist for the proper accounting of personnel time between regulated and nonregulated services; split employees should not be permitted.

MCI: No position.

US SPRINT: US Sprint has no position on this issue at this time.

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STAFF: Subject to further discovery, it appears that time is not being reported accurately and procedures are not in place to ensure accurate and complete time reporting.

ISSUE 3: Do the BellSouth cost allocation procedures reasonably assign direct costs and reasonably allocate all costs between the states in which BellSouth Corp. operates, between and among regulated and unregulated operations of Southern Bell, and between and among affiliated companies of Southern Bell?

POSITION OF PARTIES:

SOUTHERN BELL: Yes. The allocation of costs between states is not addressed by the CAM and does not have anything to do with the CAM. Even Southern Bell's allocation of costs between the states in which it operates is not addressed by the CAM. The allocation of these costs, rather, is based on long standing methodologies which have been reviewed and approved by this Commission repeatedly. This methodology has traditionally been based on a certain allocation formula involving, for example, the number of employees and the amount of assets present in each state.

With regard to identifying and allocating costs between regulated and nonregulated operations of Southern Bell, the CAM provides the appropriate guidelines. The CAM uses the Part 32 accounting process to identify costs to particular cost pools or work functions. Each cost pool is analyzed to determine the appropriate allocation criteria which include, for example, direct assignment, direct attribution, indirect attribution and unattributable. These allocations are reviewed periodically to determine if costs are being properly assigned to regulated or nonregulated operations. Thus, the CAM establishes a reasonable and supportable basis on which to determine the proper allocation of regulated and nonregulated costs and compliance with CAM prevents cross-subsidization of nonregulated operations by regulated operations.

OPC: The procedures do not reasonable assign nor reasonably allocate all costs between regulated and unregulated operations, and between and among affiliated companies of Southern Bell. Too much of the BellSouth Corporate service costs are allocated to regulated operations. BellSouth uses a general allocator to allocate a large portion of costs, and this allocator is largely



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driven by the relative sizes of the affiliated companies. Its use is analogous to charging a 195 pound man a higher price to see a movie than a 105 pound woman, merely because he is larger. This allocator (which applies, for example, in part to public relations costs, the comptroller's department, the internal audit department, the corporate planning department, and the government affairs department) should be replaced by a factor which gives some percentage weight to a equal distribution of costs to the three receiving entities: BellSouth Enterprises, Southern Bell, and South Central Bell.

Responsibility codes used to allocate BellSouth costs do not appear to allocate costs properly to the regulated subsidiaries. In addition, mark-ups from BellSouth Services do not use an appropriate cost of capital.

With respect to allocations between Southern Bell's regulated and deregulated operations, a number of allocations appear inappropriate. These include allocations for general marketing support, sales, product advertising, executive, planning, external relations, and legal. (Dismukes).

FPTA & FCTA: FPTA and FCTA have seen no indication that reasonable and readily verifiable measures have been used to assign and allocate such costs properly.

MCI: No position.

US SPRINT: US Sprint has no position on this issue at this time.

STAFF: It is very difficult to determine if the cost allocation process reasonably assigns and allocates costs between regulated and nonregulated operations, including the allocation of costs between states. Aside from the time reporting, which is covered in Issue 2, and subject to further discovery, the procedures appear to reasonably assign costs.

ISSUE 4: Are the affiliate transaction rules included in Southern Bell's CAM appropriate to safeguard against cross-subsidization and are they being followed?

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POSITION OF PARTIES:

SOUTHERN BELL: The basis for the accounting for affiliate transactions is found in Section 32.27 of the USOA. These rules govern transactions between Southern Bell and its nonregulated affiliates. The CAM uses the same affiliate transaction rules. The affiliate transaction rules adequately safeguard against cross-subsidization. For instance, assets transferred from Southern Bell to a nonregulated affiliate must be valued at tariffed rates or, if there are no tariffed rates, then the transaction must be recorded at the market rate held out to the general public or the higher of fair market value or net book cost. On the other hand, if the assets are transferred from the nonregulated affiliate to Southern Bell, the assets are transferred at either the lower of net book cost or fair market value. Thus, because the asset transfer rules are not symmetrical, they not only safeguard against cross-subsidization, they actually favor the regulated company at the expense of the nonregulated company. Moreover, as explained in the Company's position of Issue 2, Southern Bell ensures that the asset transfer rules are being complied with through internal audits, external audits and Commission oversight.

OPC: No, they are not appropriate and are not being followed. The SEARUC audit contains a number of examples, such as transactions between BAPCO and certain affiliates (Audit Report at page 297); transactions between BellSouth Enterprises Headquarters and certain affiliates (Audit Report at pages 181-183); transactions between BellSouth Services and certain affiliates (Audit report at pages 147-156); and transactions between BellSouth Corporation Headquarters and affiliates (Audit Report at pages 82-85). In a number of instances the SEARUC audit team was denied information from BellSouth, thereby thwarting their ability to conduct a proper audit. (Wright, Hord, Devlin).

FPTA & FCTA: FPTA and FCTA have seen no indication that the affiliate transaction rules afford an appropriate safeguard against cross subsidization.

MCI: No position.

US SPRINT: US Sprint has no position on this issue at this time.

STAFF: The affiliate transaction rules are not being followed exactly; however, the effect of the methods Southern Bell is using

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appears to be within the spirit of the Joint Cost Order and does not appear to be detrimental to the ratepayers.

ISSUE 5: Are there adequate mechanisms in place by which the Florida Public Service Commission can assure itself of Southern Bell's compliance with the CAM?

POSITION OF PARTIES:

SOUTHERN BELL: Yes. As described in the Company's position on Issue 2, this Commission requires an audit on CAM compliance by Southern Bell's outside auditor. In addition, the outside auditor's workpapers as well as any internal reports and workpapers relating to the CAM, are available for the Commission's review.

Because the CAM is based, to the greatest extent possible, on existing management and financial controls, and on the principle that costs should be identified and assigned using the most direct cost-causative criteria available, adequate mechanisms do exist by which the Florida Public Service Commission can assure itself of compliance with the CAM. The CAM is fully auditable and verifiable just as is any other accounting system.

OPC: No, the Florida Public Service Commission cannot assure itself that Southern Bell is complying with the CAM. Even the SEARUC audit, to which thousands and thousands of working hours were devoted, could not assure Southern Bell's compliance with the CAM. (Wright, Hord, Devlin).

FPTA & FCTA: FPTA and FCTA have seen no indication that adequate provisions are in place to assure compliance with the CAM. Such assurance and verification is currently difficult and costly. Full structural separation, on the other hand, offers a more cost effective mechanism to assure that each LEC competitive service, covers its costs plus reasonable share of joint and common overhead.

MCI: No position.

US SPRINT: US Sprint has no position on this issue at this time.

STAFF: Yes, adequate mechanisms are in place by which the Commission can assure itself of Southern Bell's compliance with the CAM; however, failure to retain proper documentation and to allow



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staff access to information may hinder the Commission in assuring itself of such compliance.

ISSUE 6: Are there expenses assigned or charged from BellCore to Southern Bell which should be capitalized rather than expensed because the expenses benefit future periods?

POSITION OF PARTIES:

SOUTHERN BELL: No. In the first instance, this is not an issue which is governed by the CAM because the CAM does not determine the underlying accounting treatment of charges.

As phrased, this issue can only relate to the matter in which Southern Bell accounts for charges from Bellcore associated with activities that are traditionally identified as "R&D". To that extent, these charges are accounted for by Southern Bell in accordance with the treatment required by generally accepted accounting principles ("GAAP") as promulgated by the Financial Accounting Standards Board ("FASB"). FASB Statement No. 2 requires that all R&D costs be expenses as incurred. In addition, the USOA, as adopted by this Commission, incorporates GAAP, and the Company is following these rules.

OPC: As presently implemented, today's customers pay for research and development costs, yet the benefit -- if any -- will accrue to future generations of customers (regulated or unregulated). This conclusion is confirmed by a NARUC audit of BellCore released in November, 1988, where it was noted that certain research projects performed by BellCore would benefit future deregulated services at the expense of regulated customers. The Commission should correct this problem by refusing to allow current ratepayers to fund research and development which will produce benefits only in the future, if at all. To the extent any ratepayer support of research and development is appropriate, it should be deferred until after the project is completed, and it is feasible to determine where, and over what time period, the benefits will flow. (Dismukes)

FPTA & FCTA: FPTA and FCTA have no position on this issue at this time.

MCI: No position

US SPRINT: US Sprint has no position on this issue at this time.



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STAFF: Subject to further discovery, staff knows of no expenses assigned or charged from BellCore to Southern Bell which should be capitalized rather than expensed.

ISSUE 7: Are and were costs associated with the recombination of the advanced system companies (and/or other reorganizational efforts) appropriately allocated between regulated and unregulated operations?

POSITION OF PARTIES:

SOUTHERN BELL: Yes. Based on the CAM, written procedures for cost identification and assignment associated with the recombination of Southern Bell Advanced Systems, Inc. were provided to and complied with by employees responsible for the recombination of Southern Bell Advanced Systems, Inc. and Southern Bell.

OPC: No, these costs were not appropriately allocated between regulated and unregulated operations. During 1988 and 1989 a significant amount of effort was expended developing the plans to recombine Southern Bell Advanced Systems into the regulated operations of the company. Executive costs allocated from BellSouth to Southern Bell do not reflect this effort. Use of the general allocator to allocate these costs did not fairly represent the recombination activities and tended to underallocate costs to the unregulated operations. In addition, a comparison of cost increases from 1988 to 1989 shows that either a portion of the additional cost due to the recombination of CPE operations is being borne by ratepayers or that the overall amount for a number of accounts is escalating well above the inflation rate. Either way, the situation is troubling. (Dismukes).

FPTA & FCTA: FPTA and FCTA have no position on this issue at this time, with the exception that to the extent costs are incurred to recombine fully separate acts on an integrated basis, such costs should be borne by the company's shareholders rather than monopoly telephone ratepayers.

MCI: No, none of the costs associated with the recombination of the advanced system companies (or other similar reorganizational efforts) should be allocated to regulated operations.

US SPRINT: US Sprint has no position on this issue at this time.

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STAFF: Subject to further discovery, staff believes that costs associated with the recombination of the advanced system companies (and/or other reorganizational efforts) have been and are being appropriately allocated between regulated and unregulated operations.

ISSUE 8: Should unregulated operations be required to compensate regulated operations for the tangible and intangible benefits it receives from operating with the regulated company, and if so, how?

POSITION OF PARTIES:

SOUTHERN BELL: No. The CAM process ensures that nonregulated operations are not only charged all appropriate incremental costs but also allocated a full share of the fixed common overhead costs that would otherwise be charged to regulated operations. In other words, fully distributed cost allocations provide a form of additional compensation from nonregulated operations to regulated operations by charging costs to nonregulated operations that are not incremental to those operations. Moreover, additional compensation from nonregulated operations should not be made for the following reasons: (1) inherent efficiencies received by nonregulated operations are the result of acting with a large, integrated, multi-product firm rather than the result of acting with a regulated company; (2) to the extent any benefits exist, the benefits flow both ways and, indeed, regulated operations may benefit more than nonregulated operations; (3) in accord with the CAM, nonregulated operations already pay full tariffed rates for regulated services which include contribution to regulated operations; (4) additional compensation requirements from nonregulated operations would impose a cost burden not imposed upon the competitors of Southern Bell's nonregulated operations, thereby increasing the cost of services to the public or, possibly, resulting in the elimination of nonregulated services; and, (5) nonregulated operations do not use any intangible assets of Southern Bell which are included in Southern Bell's regulated rate base for ratemaking purposes.

OPC: The Commission should implement a royalty fee arrangement whereby Southern Bell's unregulated operations reimburse the regulated operations for the intangible benefits of their association. These intangible benefits include the use of the

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name, logo, reputation, and goodwill associated with the BellSouth/Southern Bell system; the use of Southern Bell's personnel; the use of Southern Bell's facilities; and the benefits of being associated with a financially strong and well entrenched firm.

There are at least two options. The Commission could assess a fee on the gross revenues of Southern Bell's unregulated operations, or could assess a fee on the dollar amount of transactions between the regulated and unregulated operations. The Citizens recommend that a 5% fee be attached to the revenues of Southern Bell's unregulated operations. (Dismukes, Wright, Hord, Devlin).

FPTA & FCTA: Yes. The best solution is to prohibit the sharing of such benefits. Requiring competitive services to be offered only through the use of fully separate subsidiaries can curb and/or prevent advantages being given to LEC competitive services which are not given to competitors. If full structural separations are not required, then all tangible and intangible benefits flowing to LEC competitive services from the LEC monopoly service must be properly accounted for, and the full value of the benefit paid for by the competitive service.

MCI: Yes, unregulated operations should be required to compensate the regulated enterprise for any tangible and intangible benefits that are received from the operating relationship. Tangible benefits could be compensated for through a combination of contractual arrangements and/or approved allocations of the cost of common resources shared by the regulated and unregulated operations. Intangible benefits could be compensated for through a royalty payment or other compensation arrangement similar that to imposed by the Commission and approved by the Florida Supreme Court in the case of United Telephone Long Distance, Inc.

US SPRINT: Regulated operations should not subsidize unregulated operations, and the Commission should take all appropriate action to prevent cross subsidization between regulated and unregulated operations.

STAFF: Unregulated operations should compensate the regulated operations for any tangible and intangible benefits they receive from the regulated operations; however, the means for determining



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the proper level of compensation should only be determined on a case by case basis.

VI. EXHIBIT LIST

<u>Witness</u>	<u>Proffering Party</u>	<u>Exh. No.</u>	<u>Title</u>
Richard P. Klein	So. Bell	SBT-1	FCC Memorandum Opinion and Order Dated December 28, 1987
Richard P. Klein	So. Bell	SBT-2	BellSouth Cost Allocation Manual
Richard P. Klein	So. Bell	SBT-3	Total Expense Comparison
Richard P. Klein	So. Bell	SBT-4	Eight Expense Accounts Comparison
Kim Dismukes	OPC	OPC-1-6	Appendix to Prefiled Testimony & five schedules

VII. STIPULATIONS:

Southern Bell, OPC, and Staff have agreed to stipulate into the record the Staff Audit of Southern Bell filed under Commission Document No. 02329-91. This includes Southern Bell's response to the Audit and shall also include the supporting work papers, which are filed under Commission Document No. 02330-91. On March 22, 1991, Southern Bell submitted a Request for Confidential Classification of portions of this Audit. On April 3, 1991, OPC submitted its Opposition to Southern Bell's Request. The issue of specified confidential classification of portions of this Audit shall be addressed by separate order.



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VIII. PENDING MOTIONS:

There is presently one Request for Confidential Classification pending (see Section VII, above).

All the other pending motions listed in the Prehearing Statements of the parties have been disposed of by separate orders.

IX. RULINGS:

1. On February 5, 1990, OPC filed a Request for Production of Documents, along with a Motion to Shorten Time Period for Response. Southern Bell filed its Response and Objections and Motion for Protective Order on February 19, 1990. OPC filed its Motion to Compel on March 2, 1990. On March 14, 1990, Southern Bell filed its Response to the Motion to Compel. These Motions are all moot, as Southern Bell has now provided all the documents requested to OPC.
2. On January 25, 1990, OPC filed a Request for Production of Documents. Southern Bell filed its Response and Objections and Motion for Protective Order on March 9, 1990. OPC filed its Motion to Compel on March 26, 1990. On April 9, 1990, Southern Bell filed its Response to the Motion to Compel. Having considered the arguments of the parties, the Prehearing Officer granted OPC's Motion and directed Southern Bell to produce the items listed in the following paragraphs of OPC's Motion: (a) the second paragraph number two; (b) paragraph number three; and (c) paragraph number five.
3. Staff filed a Motion for Protective Order on March 21, 1990. OPC filed its Opposition to Staff's Motion on March 26, 1990. Southern Bell filed its Support of Staff's Motion on April 9, 1990. Staff withdrew this Motion during the Prehearing Conference.
4. On April 1, 1991, Southern Bell filed a Motion in Limine. The Prehearing Officer denied this Motion, finding that the arguments made by Southern Bell all went to the weight to be given to the evidence, not its admissibility.

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X. PROCEDURE FOR HANDLING CONFIDENTIAL INFORMATION:

In the event it becomes necessary to handle confidential information, the following procedure will be followed:

1. The Party utilizing the confidential material during cross examination shall provide copies to the Commissioners and the Court Reporter in envelopes clearly marked with the nature of the contents. Any party wishing to examine the confidential material shall be provided a copy in the same fashion as provided to the Commissioners subject to execution of any appropriate protective agreement with the owner of the material.
2. Counsel and witnesses should state when a question or answer contains confidential information.
3. Counsel and witnesses should make a reasonable attempt to avoid verbalizing confidential information and, if possible, should make only indirect reference to the confidential information.
4. Confidential information should be presented by written exhibit when reasonably convenient to do so.
5. At the conclusion of that portion of the hearing that involves confidential information, all copies of confidential exhibits shall be returned to the owner of the information. If a confidential exhibit has been admitted into evidence, the copy provided to the Court Reporter shall be retained in the Commission Clerk's confidential files.

If it is necessary to discuss confidential information during the hearing the following procedure shall be utilized.

After a ruling has been made assigning confidential status to material to be used or admitted into evidence, it is suggested that the presiding Commissioner read into the record a statement such as the following:

The testimony and evidence we are about to receive is proprietary confidential business information and shall be

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kept confidential pursuant to Section 364.093, Florida Statutes. The testimony and evidence shall be received by the Commissioners in executive session with only the following persons present:

- a) The Commissioners
- b) The Counsel for the Commissioners
- c) The Public Service Commission staff and staff counsel
- d) Representatives from the office of public counsel and the court reporter
- e) Counsel for the parties
- f) The necessary witnesses for the parties
- g) Counsel for all intervenors and all necessary witnesses for the intervenors.

All other persons must leave the hearing room at this time. I will be cutting off the telephone ties to the testimony presented in this room. The doors to this chamber are to be locked to the outside. No one is to enter or leave this room without the consent of the chairman.

The transcript of this portion of the hearing and the discussion related thereto shall be prepared and filed under seal, to be opened only by order of this Commission. The transcript is and shall be non-public record exempt from Section 119.07(1), Florida Statutes. Only the attorneys for the participating parties, Public Counsel, the Commission staff and the Commissioners shall receive a copy of the sealed transcript.

(AFTER THE ROOM HAS BEEN CLOSED)

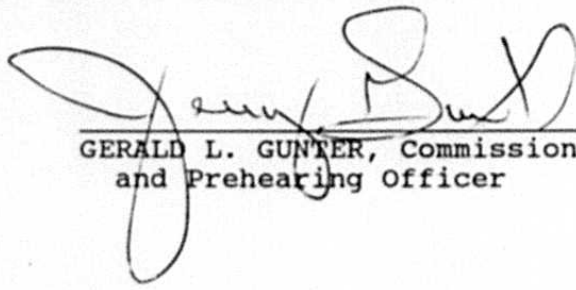
Everyone remaining in this room is instructed that the testimony and evidence that is about to be received is proprietary confidential business information, which shall be kept confidential. No one is to reveal the contents or substance of this testimony or evidence to anyone not present in this room at this time. The court reporter shall now record the names and affiliations of all persons present in the hearing room at this time.

It is therefore,

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ORDERED by Commissioner Gerald L. Gunter, as Prehearing Officer, that this Prehearing Order shall govern the conduct of these proceedings as set forth above unless modified by the Commission.

By ORDER of Commissioner Gerald L. Gunter, as Prehearing Officer, this 15th day of APRIL, 1991.

  
GERALD L. GUNTER, Commissioner  
and Prehearing Officer

( S E A L )

ABG

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.

Any party adversely affected by this order, which is preliminary, procedural or intermediate in nature, may request: 1) reconsideration within 10 days pursuant to Rule 25-22.038(2), Florida Administrative Code, if issued by a Prehearing Officer; 2) reconsideration within 15 days pursuant to Rule 25-22.060, Florida Administrative Code, if issued by the Commission; or 3) judicial review by the Florida Supreme Court, in the case of an electric,



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gas or telephone utility, or the First District Court of Appeal, in the case of a water or sewer utility. A motion for reconsideration shall be filed with the Director, Division of Records and Reporting, in the form prescribed by Rule 25-22.060, Florida Administrative Code. Judicial review of a preliminary, procedural or intermediate ruling or order is available if review of the final action will not provide an adequate remedy. Such review may be requested from the appropriate court, as described above, pursuant to Rule 9.100, Florida Rules of Appellate Procedure.