

## BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

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|---|---|----------------------|
| In re: Development of local exchange      | ) | DOCKET NO. 900633-TL |
| company cost of service study methodology | ) | ORDER NO. 24910      |
| <hr/>                                     |   | ISSUED: 8/13/91      |

The following Commissioners participated in the disposition of this matter:

THOMAS M. BEARD, Chairman  
 J. TERRY DEASON  
 BETTY EASLEY  
 GERALD L. GUNTER  
 MICHAEL MCK. WILSON

NOTICE OF PROPOSED AGENCY ACTION  
ORDER REFINING SCOPE OF PROCEEDING

BY THE COMMISSION:

I. BACKGROUND

By Order No. 23474 issued September 12, 1990, this Commission initiated the instant proceeding to develop a uniform cost study methodology for local exchange companies (LECS). Our initial goal was to solicit the views of affected parties, in order to identify the needs to be met by a cost study methodology and to determine the types of cost studies required to fulfill these needs. The initial issues posed to the parties included the proposed uses of a cost study, the differences between cost and price, the treatment of shared costs, the definition of cost by function or service category, the detection of cross subsidy, and the currently available cost methodologies.

To provide an opportunity for parties to present their views, several workshops were held. As a starting point, a task force was established to identify and define the function elements that would be the focus of a cost methodology. A list of basic functional cost elements, as well as many of their subcomponents, was tentatively defined and subsequently refined. In addition, since the LECs have cost models for most of the key functional network elements, the scope of the examination was expanded to include a review and evaluation of these models. The various views on the appropriate cost methodology distill into two basic approaches, incremental and embedded.

At the request of some parties, a separate task force was formed to investigate issues relating to cross-subsidization between monopoly and competitive services. To provide a general framework for discussion, information was solicited regarding the interpretation of the newly adopted provision in Chapter 364,

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Florida Statutes, the types of studies useful for detection of cross-subsidies, and other relevant documentation on the subject. Generally, two distinct and conflicting viewpoints have emerged. Various parties asserted that the no consensus could be reached by the participants; certain parties thought that guidance was required before any progress could be made. No further meetings have been held.

## II. INTRODUCTION

The principal goal of this proceeding is to establish a uniform methodology for performing cost studies. The information presented thus far in this proceeding revolves around three key issues: 1) the development of a costing methodology which generates cost results for individual services; 2) the definition of cross-subsidy of effectively competitive LEC services by monopoly LEC services consistent with the requirements of Chapter 364, and the appropriate means for detecting the presence of cross-subsidization; and 3) the proper treatment of shared costs to ensure that they are recovered in a fair and equitable manner from the LEC's various services.

In view of the diversity of views thus far, it appears appropriate to refine the scope of this proceeding. As set forth in greater detail below, we adopt a functional building block approach for determining price floors for specific services. In addition, we also find it appropriate to include an examination of both an incremental costing approach and an embedded costing approach. We view each approach as an appropriate tool.

## III. FUNCTIONAL APPROACH

Ideally, one would be able to determine all of the discrete cost components of a firm and then be able to identify the unique service(s) which gave rise to each particular component. These cost components could be viewed as the firm's production building blocks, or functional production elements.

The "function approach" refers primarily to the identification of the major functional network components. The function task force continues to identify the relevant subcomponents that comprise each of these categories, with a goal of ultimately identifying all such pertinent cost subcomponents. These functional cost subcomponents or basic building blocks should represent the lowest common denominators for a given unique

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function or operation. Once the cost of each of the network components is determined, at the appropriate level of disaggregation, the costing of individual services basically would be an additive process.

Our initial examination of the functional approach persuades us that this is an appropriate direction to pursue in the development of a uniform cost methodology. We note that this function approach is directly comparable to the architecture incorporated in the Commission's Florida Private Line/Special Access Cost Study Manual. While the Private Line Manual identifies the "building blocks" from which private line and special access services are created, the goal of the proposed approach is to yield the basic "building blocks" from which all LEC services can be constructed.

#### VI. INCREMENTAL COST APPROACH

An incremental approach focuses on the identifiable production costs caused by offering a given service. Incremental costs are appropriate for evaluating pricing decisions since they represent the cost associated with the production of the next unit at the margin. Because of their efficiency properties they are the proper standard for pricing; by knowing the incremental cost of a product one is able to determine if a given price level is welfare-maximizing. The costs generated using an incremental methodology would include only those cost components which can reasonably be attributed directly to a given service, and no arbitrary allocations of joint or common costs would be made; as such, the cost study results should be viewed as floor costs and thus represent only lower bounds for pricing individual services.

It should be emphasized here that incremental cost results are but one piece of the overall regulatory pricing puzzle. While these cost results can be of particular value in designing individual rates, they are silent as to the specific price level that would be appropriate for a service, as well as the aggregate price levels for all services. This feature is advantageous, in that it separates costing and pricing: costing is properly restricted to the production processes; pricing uses the incremental cost results in conjunction with other factors to perform its role.

In determining the price level for a given service (especially a new offering) an analyst presumably would add a markup to the service's incremental cost in order to provide a contribution to

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the firm's common costs; various noncost-related factors could be evaluated in arriving at a reasonable and sustainable contribution level. Additional information that might be required for the pricing process could include analyses of product demand characteristics, data concerning historic and projected product profitability, and evaluations of possible externalities, as well as general policy considerations.

Upon consideration, we find it appropriate to adopt an incremental cost approach for use in our establishment of a uniform costing methodology.

#### V. EMBEDDED COST APPROACH

Embedded cost methodologies represent "top down" approaches, in that they derive service- or category-specific costs from the firm's total costs. An embedded cost study is an historical methodology in that it utilizes the accounting costs on the company's books; as such, it is not forward-looking but rather provides a snapshot of prior period results.

Most embedded cost studies allocate the firm's total costs between its individual services. These studies typically allocate all costs, whether or not a causal relationship can be determined. Where possible, costs are directly assigned to specific categories. Portions of other costs are indirectly attributed to a given service category based on an allocator such as relative minutes of use. Other costs may be residually allocated such as executive salaries and benefits.

Since embedded studies focus on historic conditions, it is generally considered that it would be coincidental if prices based on such study results approximated those emerging in competitive markets. At best, embedded studies may provide information regarding the results of prior pricing decisions; however, they do not appear to provide meaningful information useful for prospective pricing of individual services. Notwithstanding the problems inherent in an embedded analysis, a knowledge of a firm's embedded costs can be an important piece of information in the overall pricing process. Accordingly, we find it appropriate to include an examination of embedded cost in this proceeding. We anticipate an examination of the types of embedded studies available, as well as research into their proper application and effectiveness for rate design applications. In particular, we envision an evaluation of embedded studies such as embedded direct analyses to ascertain if and in what form they may be applicable in a rate case setting for yielding information useful for pricing broad groups of like

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services. If deemed appropriate, we would consider such studies to represent another important pricing tool available to the Commission.

#### VI. CROSS SUBSIDIZATION

At the Cross-Subsidy Task Force meeting on January 10, 1991, representatives of local exchange companies, interexchange carriers, pay telephone providers, cable television companies, and large telecommunications users were given the opportunity to present comments on the subject of cross-subsidy and the methods whereby it could be detected. Although there was some agreement between a few of the parties, no consensus could be reached even as to the definition of cross-subsidy.

Several aspects and perspectives were brought up at the meeting that appear to go beyond the development of LEC costing methodologies. There was concern regarding the proper legal interpretation and requirements of the revisions to Chapter 364, especially Section 364.338. Several parties asserted that a fully distributed cost approach was required, although fully separate subsidiaries for competitive services was preferable; others contended that no specific methodology was required by the statutes; still others stated that a fully distributed approach was implied by Chapter 364.

Upon consideration, it appears that many of the issues raised by the Cross-Subsidy Task Force, though not completely unrelated, go beyond the intended scope of this docket. Given the progress made by the Function Task Force towards evaluating costing issues, it is preferable to limit the scope of this docket to the primary subject matter originally envisioned: the development of costing methodologies for LEC services. Absent this scope limitation, we are concerned that meaningful progress in the docket will be hampered.

Accordingly, we find it appropriate that the issues regarding cross-subsidization arising from the changes to Chapter 364 shall be addressed in a separate proceeding. Docket No. 910757-TP has been established to provide the forum to address the issues of cross-subsidization. All parties and interested persons are invited to file briefs or comments in the new proceeding regarding cross subsidization requirements of Chapter 364. Parties and interested persons to Docket No. 910757-TP shall be notified of the filing schedule.



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Based on the foregoing, it is

ORDERED by the Florida Public Service Commission that the scope of this proceeding is further refined consistent with our decisions in the body of this Order. It is further

ORDERED that the issues regarding cross-subsidization are to be addressed in Docket No. 910757-TP as set forth in the body of this Order. It is further

ORDERED that the Parties and Interested Persons may file comments and briefs on the regulatory requirements of Chapter 364, Florida Statutes, on the issue of cross-subsidization on a date to be announced in Docket No. 910757-TP as set forth in the body of this Order.

By ORDER of the Florida Public Service Commission, this 13th day of AUGUST, 1991.

  
STEVE TRIBBLE, Director  
Division of Records and Reporting

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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,

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Florida 32399-0870, by the close of business on  
9/3/91.

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 sewer 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.