SCANNED

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

Comprehensive Review of the Revenue Requirements and Rate Stabilization Plan of Southern Bell Telephone & Telegraph Company)

Docket No. [redacted]
Filed: November, 1993

DIRECT TESTIMONY

OF

STEPHEN ALAN STEWART

On Behalf of the Citizens of The State of Florida

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

TESTIMONY

OF

STEPHEN ALAN STEWART

DOCKET NO. 920260-TL

Q. Please state your name, address and occupation.

A. My name is Stephen A. Stewart. My business address is 111 West Madison Street, Room 812, Tallahassee, Florida, 32399-1400. I am employed by the Office of Public Counsel as a Legislative Analyst.

Q. Please describe your educational background and business experience?

A. I graduated from Clemson University with a Bachelor of Science degree in Electrical Engineering in December, 1984. I received a Master's degree in Political Science from Florida State University in August, 1990, and I have completed all but the dissertation requirement for a Doctorate in the area of Public Policy from FSU.

From January, 1985, until October, 1988, I was employed by Martin Marietta Corporation and Harris Corporation as a Test Engineer. In July, 1989, I accepted an internship with the Science, Industry and Technology Committee in the Florida House of Representatives. Upon expiration of the internship I accepted employment with the Office of the Auditor General in August, 1990, as a Program Auditor. In this position I was responsible for evaluating and analyzing public programs to determine their impact and cost-effectiveness. In October, 1991, I accepted my current position with the Office of Public Counsel.

Q. What are your responsibilities with the Office of Public Counsel?

A. I am responsible for analyzing economic and engineering data of regulated utilities for the purpose of assisting the Public Counsel in matters before the Public Service Commission.

Q. Have you ever testified before this commission?

A. Yes. I have testified on behalf of the Office of Public Counsel in Tampa Electric's request for a rate increase (Docket No. 920324-EI) and in Southern States Utilities' request for a rate increase (Docket No. 920655-WS). I have also filed direct testimony on behalf of the Office of the Public Counsel addressing incentives for off-system sales of capacity and energy by investor-owned utilities (Docket No. 930055-EU) and Florida Power Corporation's request for a return on equity for investment in the Sunshine Pipeline (Docket No. 930281-EI).

Q. Would you please summarize the issues you address in your testimony?

A. In the first part of my testimony I address the Southern Bell incentive plan by rebutting the testimony of Southern Bell witness Reid and presenting comparisons between Southern Bell and other telecommunications companies over the period of the incentive plan using data filed with the Florida Public Service Commission. The comparisons indicate that

Southern Bell's performance, based on various measures of efficiency, was not enhanced by the incentive plan. The second part of my testimony addresses Southern Bell's projected cost savings associated with BST Reengineering in the years 1995 and 1996. The Office of Public Counsel supports a step decrease in each of these years to return to ratepayers indentifiable cost reductions associated with the Southern Bell reengineering program.

Q. Have you prepared an exhibit to your testimony?

A. Yes. I have prepared an exhibit entitled, "Exhibit of Stephen A. Stewart," which consists of 12 pages and has been identified as Exhibit No.____.

I. SOUTHERN BELL INCENTIVE PLAN

Q. What is the Southern Bell incentive plan?

A. The Southern Bell incentive plan, approved by the Florida Public Service Commission in Order 20162, implements a sharing concept which allows ratepayers to share profits with the regulated utility when profits reach a specific level.

Q. Why was the Southern Bell plan approved by the Commission?

A. The incentive plan was implemented to address possible disincentives associated with traditional rate of return (ROR) regulation. For example, in authorizing Southern Bell's incentive plan, the Commission said:

> Two major disincentives of ROR regulation discussed at the hearings were the incentive to overinvest and the lack of incentive to innovate, reduce costs and introduce new services....We do believe that this program will provide more incentive to Southern Bell than the present practices of regulation. This new regime should encourage efficiency and innovation by Southern Bell. (10:315-316)

Q. How did Southern Bell characterize the future impact of the incentive plan?

A. Dr. William Taylor, a witness for Southern Bell in Docket No. 880079-TL, stated in his rebuttal testimony that:

> Such improvements in incentives will provide immediate and direct benefits to Florida ratepayers in terms of lower costs and improved services.

In addition, Mr. David Denton stated, in his testimony on behalf of Southern Bell in this docket, that:

> Regulatory incentive plans, such as Florida's incentive sharing plan, are designed to reward both long term planning and short

term actions to reduce costs and improve services.

Q. **What conditions must be met for the Southern Bell incentive plan to be considered successful?**

A. Based on the analysis of staff in Order No. 20162 and the testimony of Southern Bell witnesses, the incentive plan should result in lower costs and more improved services than would have occurred under traditional rate of return (ROR) regulation. It is important to note that Southern Bell has the burden of showing this commission that the incentive plan produced results which would not have occurred under traditional ROR regulation.

Q. **Has Southern Bell evaluated the impact of the incentive plan?**

A. Yes. Mr. Walter Reid, testifying on behalf of Southern Bell, presents a compilation of finance data over the period of 1984-92. He compares performance measurements before and after the incentive plan was adopted and implies that the incentive plan has resulted in a decreasing cost of service to ratepayers.

Q. **What is your assessment of Mr. Reid's evaluation of the impact of the Southern Bell incentive plan?**

A. It is my view that Mr. Reid's analysis provides no logical ground for evaluating the impact of the incentive plan. Mr. Reid's findings and conclusions rest solely on the fact that the cost of service for Southern Bell decreased over the period of the incentive plan. However, this fact alone does not support the argument that incentive plan was the impetus for the decrease in costs. For example, what if the telecommunications industry has experienced declining costs over the period of Southern Bell's incentive plan? If so, this would indicate that Southern Bell is just keeping up with the rest of the industry.

Q. **Do you have any other comments regarding Mr. Reid's analysis?**

A. Yes. There are couple of additional points I would like to make. First, Mr. Reid fails to make any comparison with other telecommunication companies. This is major shortcoming of his analysis. It is accepted practice by policy analysts to use comparisons to ascertain the impact of new policies. It would seem appropriate, in this case, to use comparisons of corporate performance to evaluate the impact of new management strategies. Second, I believe Mr. Reid's use of intrastate data does not give the full picture when attempting to evaluate the efficiency of a utility. While intrastate data is needed for ratemaking purposes, using total company data to evaluate the efficiency of a corporation is more representative of overall management decisions and allows for comparisons between utilities.

Q. Have you completed an evaluation of the Southern Bell incentive plan?

A. Yes. I have made several comparisons between Southern Bell and the other three major LEC's in state of Florida over the period that Southern Bell was operating under the incentive plan using three different measures of efficiency. The first comparison is based on operating revenue per average access line. This is a measure used by Southern Bell witness Reid to support his conclusion that incentive regulation is working (see pages 11-14). The second comparison is based on the O&M expense per average access line with and without depreciation. The third comparison is based on a ratio of O&M expense and total operating revenue.

Q. Why did you select O&M expense per average access line as a measure of the effectiveness of the incentive plan?

A. One of the benefits expected from the implementation of the incentive plan is a decrease in the costs needed to provide service. Under the Southern Bell plan it was expected that management would work harder to cut costs and to discover new efficiencies. The results of such behavior should be lower O&M expenses per average access line. In fact, one would expect the decrease in O&M expense per average access for Southern Bell to be greater than for other telephone companies not under incentive regulation.

Q. What is the relevance of the other measure you use in your comparisons?

A. The ratio of O&M expense to total operating revenue gives another indication of how well Southern Bell is controlling costs. In addition, it gives an indication of how well Southern Bell has capitalized on new revenue opportunities. As Southern Bell witness Denton stated, the intent of the incentive plan was to "improve Southern Bell's incentive to increase efficiencies and to seek out new revenue." Thus, a ratio of O&M expense and operating revenue should be an good indicator of how well Southern Bell has performed during the incentive plan.

Q. Could you summarize what your comparisons of Southern Bell and the other LEC's indicate?

A. The first comparison is on page 1 of my exhibit and is titled "COMPARISON OF TOTAL OPERATING REVENUE PER AVERAGE ACCESS LINE FOR FLORIDA LEC'S FROM 1988-92". This comparison shows that over the period of the incentive plan all four LEC's in Florida experienced declining revenue per access line. Southern Bell and GTE experienced about the same decrease over the 4 year period. GTE operated under traditional ROR regulation during this entire period. Thus, it would seem inappropriate to conclude that the incentive plan was the driving force behind Southern Bell's decrease in revenue per access line.

The second comparison is on page 2 of my exhibit and is titled "COMPARISON OF TOTAL COMPANY O&M EXPENSE PER AVERAGE ACCESS LINE FOR FLORIDA LEC'S FROM 1988-92". This comparison shows that all the Florida LEC's are in a declining cost mode. Both GTE and CENTEL had a higher percent change over the period of the incentive plan than Southern Bell. In addition, the comparison shows that the rate of reduction in Southern Bell's O&M expenses per average access line has been less than the rate of reduction in the weighted average of the other three LEC's since 1988.

The third comparison is on page 3 of my exhibit and is titled "COMPARISON OF TOTAL COMPANY O&M EXPENSE (WITHOUT DEPRECIATION) PER AVERAGE ACCESS LINE FOR FLORIDA LEC'S FROM 1988-92". This comparison shows essentially the same trend as the previous comparison. Taking into consideration depreciation expense, both GTE and CENTEL had a higher percent change under ROR regulation than Southern Bell did under incentive regulation. And as with the previous comparison, the comparison shows that the rate of reduction in Southern Bell's O&M expenses per average access line has been less than the rate of reduction in the weighted average of the other three

LEC's since 1988.

The fourth comparison is on page 4 of my exhibit and is titled "COMPARISON OF TOTAL COMPANY O&M EXPENSE PER TOTAL COMPANY OPERATING REVENUE FOR FLORIDA LEC'S FROM 1988-92." This comparison shows that the only LEC in Florida to show a decrease in O&M expense per operating revenue over the period of the incentive plan was GTE. This is also the case when controlling for the effects of depreciation as is shown on page 5 of my exhibit by the comparison titled "COMPARISON TOTAL COMPANY O&M EXPENSE (W/O DEPRECIATION) PER TOTAL COMPANY OPERATING REVENUE."

In summary, the comparisons I have presented show little evidence that the incentive plan has resulted in behavior by Southern Bell which would not have been expected under traditional ROR regulation. Southern Bell's performance during the incentive plan does not stand out from the other Florida LEC's who did not operate under incentive regulation. In fact, looking at the changes in the performance measures for all the LEC's over the period of the incentive plan, the data indicates that GTE has the best performance among the Florida LEC's.

Q. Did you make any other comparisons?

A. Yes. In addition to the in-state comparisons between the major LEC's, pages 6-10 of my exhibit show comparisons of various segments of telecommunications industry over the period of the Southern Bell incentive plan using data from "Statistics of Communications Common Carriers", published by the FCC. These comparisons show that from 1988 to 1992 the telecommunications industry has experienced declining revenue per access line, declining O&M expense per access line, and in between a zero and 3% change in the ratio of O&M expense per operating revenue.

Q. What implications do these comparisons have for the Southern Bell incentive plan?

A. These comparisons indicate that declining costs per access line has been the obvious trend in the telecommunications industry over the last five years. Thus, it is not surprising to find that costs per access line have declined for Southern Bell over this period. To use this fact as an indication of the success of the incentive plan, as Mr. Reid does in his testimony, renders an incomplete assessment of Southern Bell's performance over this period.

Q. What is the position of the Office of Public Counsel with regard to the

future of the Southern Bell incentive plan?

A. Based on the comparisons I have completed, the convergence of the data clearly indicates that the Southern Bell incentive plan has not resulted in outcomes which could not have occurred under traditional ROR regulation. In addition, Southern Bell's record is poor in terms of quality of service over the period of the incentive plan as discussed by OPC witness Poucher in his testimony. The OPC recommends that the Commission suspend the Southern Bell incentive plan and return this public utility to traditional ROR regulation. I hasten to add that this finding does not suggest that the OPC is against incentive regulation. The OPC recognizes the possible benefits of various forms of incentive regulation when appropriate controls and measurements are established to protect ratepayers. However, in this case, the OPC believes the evidence in this docket fully supports the decision to suspend the Southern Bell incentive plan.

II. IMPACT OF COST SAVINGS PROGRAM

Q. Has Southern Bell implemented any cost savings programs that will result in savings beyond the test year?

A. According to Citizen's 39th Set of Interrogatories, Item No. 988, which is attached as pages 11-12 of my exhibit, Southern Bell has projected $69.7 million and $130.7 million in total company savings, net of cost, for 1995 and 1996, associated with BST Reengineering.

Q. **How does the Office of Public Counsel propose these savings be handled?**

A. It is the position of the Office of Public Counsel that the Commission should implement a step decrease in 1995 and 1996 to allow the ratepayers to recover the savings that will occur during these years. Such an approach is consistent with Commission decisions over the last two years. For example, in the last two major electric rate cases (see Orders PSC-93-0165-FOF-EI and PSC-92-1197-FOF-EI) the Commission has allowed step increases to recognize projected costs. In these cases the regulated utility successfully argued that step increases were warranted because projected costs were needed to provide reliable service. In this case, Southern Bell is projecting reductions in costs that are not needed to provide reliable service, while not proposing a warranted step decrease. A step decrease would seem to be an appropriate measure for the Commission to implement.

Q. **Does this conclude your testimony, prefiled on November 8, 1993?**

A. Yes.

EXHIBIT OF STEPHEN A. STEWART

COMPARISON OF TOTAL OPERATING REVENUE PER AVERAGE ACCESS LINE FOR FLORIDA LEC'S FROM 1988-92 (Dollars)

COMPANY	TYPE OF REGULATION	1988	1989	1990	1991	1992	Percent Change 1988-92
SOUTHERN BELL	INCENTIVE	733	701	690	661	637	-9.80%
GTE	ROR	738	676	660	671	640	-9.07%
UNITED	ROR	658	630	624	609	608	-7.43%
CENTEL	ROR	594	548	565	548	514	-7.68%

NOTES:
Source: Schedules I and S of Annual Report filed by LEC's.
Average Acess Lines calculated using the number of year end access lines in service.

COMPARISON OF TOTAL COMPANY O&M EXPENSE PER AVERAGE ACCESS LINE FOR FLORIDA LEC'S FROM 1988-92 (Dollars)

COMPANY	TYPE OF REGULATION	1988	1989	1990	1991	1992	Percent Change 1988-92
SOUTHERN BELL	INCENTIVE	520	505	499	489	471	-9.47%
GTE	ROR	516	502	455	454	433	-16.21%
UNITED	ROR	461	434	432	410	445	-3.48%
CENTEL	ROR	448	423	433	429	401	-10.50%
AVERAGE OF OTHER LEC'S (GTE,UNITED,&CENTEL)		492	469	445	436	434	-11.85%
SOUTHERN BELL DEVIATION FROM AVERAGE		28	37	54	53	37	

NOTES:
Source: Schedules I and S of Annual Report filed by LEC's.
Average Acess Lines calculated using the number of year end access lines in service.
Southern Bell O&M expense for 1992 adjusted for impact of Hurricane Andrew. The $43 million adjustment is based on testimony of Mr. Reid (see pages 17-18).

COMPARISON OF TOTAL COMPANY O&M EXPENSE (WITHOUT DEPRECIATION) PER AVERAGE ACESS LINE FOR FLORIDA LEC'S FROM 1988-92 (Dollars)

COMPANY	TYPE OF REGULATION	1988	1989	1990	1991	1992	Percent Change 1988-92
SOUTHERN BELL	INCENTIVE	355	349	343	336	323	-9.13%
GTE	ROR	356	347	319	318	297	-16.70%
UNITED	ROR	308	305	301	280	291	-5.66%
CENTEL	ROR	335	318	326	321	308	-8.00%
AVERAGE OF OTHER LEC's (GTE, UNITED, & CENTEL)		338	327	313	305	296	-12.56%
SOUTHERN BELL DEVIATION FROM AVERAGE		17	22	30	30	27	

NOTES:
Source: Schedules I and S of Annual Reports filed by LEC's.
Average Acess Lines calculated using the number of year end access lines in service.
Southern Bell O&M expense for 1992 adjusted for impact of Hurricane Andrew. The $43 million adjustment is based on testimony of Mr. Reid (see pages 17-18).

COMPARISON OF TOTAL COMPANY O&M EXPENSE PER TOTAL COMPANY OPERATING REVENUE FOR FLORIDA LEC'S FROM 1988-92 (Dollars)

COMPANY	TYPE OF REGULATION	1988	1989	1990	1991	1992	Percent Change 1988-92
SOUTHERN BELL	INCENTIVE	70.90%	72.13%	72.35%	73.98%	73.83%	2.93%
GTE	ROR	70.00%	74.25%	68.95%	67.62%	67.58%	-2.42%
UNITED	ROR	70.15%	68.91%	69.20%	67.33%	73.21%	3.05%
CENTEL	ROR	75.49%	77.18%	76.66%	78.24%	78.07%	2.57%

NOTES:
Source: Schedules I and S of Annual Report filed by LEC's.
Average Acess Lines calculated using the number of year end access lines in service.
Southern Bell O&M expense for 1992 adjusted for impact of Hurricane Andrew. The $43 million adjustment is based on testimony of Mr. Reid (see pages 17-18).

COMPARISON OF TOTAL COMPANY O&M EXPENSE (W/O DEPRICIATION) PER TOTAL COMPANY OPERATING REVENUE FOR FLORIDA LEC'S FROM 1988-92 (Dollars)

COMPANY	TYPE OF REGULATION	1988	1989	1990	1991	1992	Percent Change 1988-92
SOUTHERN BELL	INCENTIVE	48.49%	49.87%	49.73%	50.74%	50.69%	2.19%
GTE	ROR	48.30%	51.36%	48.27%	47.48%	46.37%	-1.94%
UNITED	ROR	46.91%	48.49%	48.29%	45.99%	47.85%	0.94%
CENTEL	ROR	56.42%	58.02%	57.62%	58.50%	59.97%	3.56%

NOTES:
Source: Schedules I and S of Annual Report filed by LEC's.
Average Acess Lines calculated using the number of year end access lines in service.
Southern Bell O&M expense for 1992 adjusted for impact of Hurricane Andrew. The $43 million adjustment is based on testimony of Mr. Reid (see pages 17-18).

Southern Bell
Docket No. 920260-TL
Exhibit ___ (SAS)

COMPARISON OF TOTAL OPERATING REVENUE PER ACCESS LINE FOR VARIOUS SEGMENTS OF THE TELECOMMUNICATIONS INDUSTRY FROM 1988-92 (Dollars)

COMPANY	1988	1989	1990	1991	1992	Percent Change 1988-92
ALL LOCAL EXCHANGE COMPANIES	664	657	643	625	620	-6.55%
RBOC'S	646	638	624	603	600	-7.13%
OTHER LOCAL EXCHANGE COMPANIES	751	744	733	728	715	-4.73%

NOTES:
Source: Data from "Statistics of Communications Common Carriers", published by the Federal Communications Commission, 1988-1992.

COMPARISON OF TOTAL O&M EXPENSE PER ACCESS LINE FOR VARIOUS SEGMENTS OF THE TELECOMMUNICATIONS INDUSTRY FROM 1988-92 (Dollars)

COMPANY	1988	1989	1990	1991	1992	Percent Change 1988-92
ALL LOCAL EXCHANGE COMPANIES	475	481	473	464	453	-4.65%
RBOC'S	463	469	461	452	441	-4.87%
OTHER LOCAL EXCHANGE COMPANIES	531	536	528	519	509	-4.18%

NOTES:

Source: Data from "Statistics of Communications Common Carriers", published by the Federal Communications Commission, 1988-1992.

COMPARISON OF O&M EXPENSE (W\O DEPRECIATION) PER ACCESS LINE FOR VARIOUS SEGMENTS OF THE TELECOMMUNICATIONS INDUSTRY (Dollars)

COMPANY	1988	1989	1990	1991	1992	Percent Change 1988-92
ALL LOCAL EXCHANGE COMPANIES	337	345	341	340	329	-2.30%
RBOC'S	328	335	332	332	321	-2.34%
OTHER LOCAL EXCHANGE COMPANIES	379	390	383	378	369	-2.63%

NOTES:
Source: Data from "Statistics of Communications Common Carriers", published by the Federal Communications Commission, 1988-1992.

COMPARISON OF OPERATING EXPENSE PER OPERATING REVENUE FOR VARIOUS SEGMENTS OF THE TELECOMMUNICATIONS INDUSTRY FROM 1988-92 (Dollars)

COMPANY	1988	1989	1990	1991	1992	Percent Change 1988-92
ALL LOCAL EXCHANGE COMPANIES	71.59%	73.15%	73.57%	74.20%	73.05%	1.46%
RBOC'S	71.79%	73.44%	73.94%	74.96%	73.54%	1.75%
OTHER LOCAL EXCHANGE COMPANIES	70.76%	72.03%	72.09%	71.26%	71.16%	0.40%

NOTES:
Source: Data from "Statistics of Communications Common Carriers", published by the Federal Communications Commission, 1988-1992.

COMPARISON OF OPERATING EXPENSE (W/O DEPRECIATION) PER OPERATING REVENUE FOR VARIOUS SEGMENTS OF THE TELECOMMUNICATIONS INDUSTRY (Dollars)

COMPANY	1988	1989	1990	1991	1992	Percent Change 1988-92
ALL LOCAL EXCHANGE COMPANIES	50.80%	52.48%	52.96%	54.42%	53.11%	2.31%
RBOC'S	50.86%	52.49%	53.15%	55.08%	53.49%	2.63%
OTHER LOCAL EXCHANGE COMPANIES	50.54%	52.40%	52.22%	51.89%	51.65%	1.11%

NOTES:
Source: Data from "Statistics of Communications Common Carriers", published by the Federal Communications Commission, 1988-1992.

REQUEST:

COST SAVINGS PROGRAM. Refer to the Company's MFR Schedule C-19, pages 2 and 9 of 19. Explain and show the basis of the 1993 annual savings associated with Data Center Deployment and Automated Operations Centralization (AOC) which resulted in 1993 savings of $12.7 million and the re-engineering of 13 core telecommunications work processes which resulted in a cost in 1993 of $12.2 million.

a. State the going forward level of cost and separately, savings as a result of these programs.

RESPONSE:

The 1993 savings information ($12.7 million) on MFR Schedule C-19, page 2, associated with Data Center Deployment (DCD) and Automated Operations Centralization (AOC) results from headcount savings of $6,150,000 in 1992 (123 people) and savings of $6,550,000 in 1993 (131 people) for a cumulative regional total of $12,700,000.

The 1993 cost of $12.2 million (MFR Schedule C-19, page 9), associated with the re-engineering of 13 core telecommunications work processes (excluding the AOC/DCD impact) is the result of the following:

	1993
Savings (force reduction and expense elimination)	$ 19.1M
Cost (implementation expenses)	66.8M
Net BST	-47.7M
Net Florida (by applying general allocator to BST to derive FLA share)	$-12.2M

a. Projected costs are divided between Capital and Expense for AOC/DCD.

	1994	1995
Capital*	$15,588,686	$2,436,455
Expense*	$14,416,871	$5,302,626

Cumulative savings* projected for AOC/DCD for the period 1994-1995 are as follows:

1994	$20,400,000	(408 cumulative headcount)
1995	$26,600,000	(532 cumulative headcount)

* AOC/DCD began in 1988 and is due to be completed by end of year, 1995. These figures are regional totals.

The following is the current projection of savings and costs associated with BST Reengineering (excluding AOC/DCD) for the years 1994 - 1996:

	1994	1995	1996
Savings	$ 128.7	376.9	545.8
Cost	$ 101.4	104.5	35.2
NOR	$ 27.3	272.4	510.6
NOR (FL)	$ 7.0	69.7	130.7

RESPONSE PROVIDED BY:

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