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June 28, 1999

Mr. David Waddell
Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243

Re: Docket No. 98-00626; UTSE 1998 Price Regulation Filing
UTSE Post Hearing Brief

Dear Mr. Waddell:

Pursuant to Chairman Malone's request at the May 13, 1999 Hearing in this case, enclosed for filing are the original and thirteen copies of United Telephone-Southeast, Inc.'s Post Hearing Brief.

Please contact me if you have any questions.

Very truly yours,

James B Wright

James B. Wright

JBW:sm
Enclosures

CC: Consumer Advocate (with enclosure)
Guy Hicks (with enclosure)
Paul Monk (with enclosure)
John Hanlin (with enclosure)
Steve Parrott (with enclosure)
Dennis Wagner (with enclosure)
Laura Sykora (with enclosure)

#17424

BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE: UNITED TELEPHONE-SOUTHEAST, INC.)
TARIFFS TO REFLECT PROPOSED CHANGES) DOCKET NO. 98-00626
UNDER PRICE REGULATION PLAN)

UNITED TELEPHONE-SOUTHEAST, INC.
POST HEARING BRIEF

COMES NOW United Telephone-Southeast, Inc. ("United"), and pursuant to the request of the Chairman of the Tennessee Regulatory Authority ("Authority") files this post hearing brief regarding the three issues addressed at the Hearing held in this case on May 13, 1999.

BACKGROUND

At a March 9, 1999 prehearing conference in this case, two issues were identified for consideration at the Hearing. (See page 4 of the April 16, 1999 *Report and Recommendation of the Pre-Hearing Officer From the Pre-Hearing Conference Held on March 9, 1999*, herein called "Hearing Officer's Report"). One issue deals with whether price adjustment amounts can accumulate from year to year, or must increases be taken only in the year in which the event giving rise to the increase occurs, that is, "use it or lose it". The second issue deals with whether United's filing appropriately dealt with the reduced base fee revenues under a directory publishing agreement with an affiliate. At an Authority Conference held on April 27, 1999, the Director's took action on the

Hearing Officer's Report and issued an *Order Adopting Report and Recommendation of the Pre-Hearing Officer as Amended* ("Approval Order") dated April 30, 1999.

At the May 13, 1999 Hearing in this case, testimony was provided by two witnesses: Mr. C. Steve Parrott for United, and Mr. Robert T. Buckner for the Office of the Attorney General, Consumer Advocate Division ("CAD"). During the May 13, 1999 Hearing, a third issue relating to pay telephone subsidies was added by direction of the Directors (See the Transcript of the May 13, 1999 Hearing, at page 43; hereinafter cited as "Tr. p 282").

Within this context, United addresses the three issues as set forth in the Authority's April 30, 1999 Order Adopting Report and Recommendation of the Pre-Hearing Officer as Amended, and as added at the hearing, as follows.

ISSUE 1: DOES UNITED'S OCTOBER 1998 FILING COMPLY WITH THE TRA's APPROVED METHODOLOGY FOR PRICE ADJUSTMENTS UNDER T.C.A SECTION 65-5-209(e)?

As a price regulated company, United is subject to the provisions of T.C.A. Section 65-5-209 with regard to changes in its prices. Subsection (e) thereof contains a limitation with respect to price changes. This section reads as follows:

> "(e) A price regulation plan shall maintain affordable basic and non-basic rates by permitting a maximum annual adjustment that is capped at the lesser of one half (1/2) the percentage change in inflation for the United States using the gross domestic product-price index (GDP-PI) from the preceding year as the measure of inflation, or the GDP-PI from the preceding year minus two (2) percentage points. An incumbent local exchange telephone company may adjust its rates for basic local exchange telephone services or non-basic services only so long as its aggregate

> revenues for basic local exchange telephone services or non-basic services generated by such changes do not exceed the aggregate revenues generated by the maximum rates permitted by the price regulation plan."

United became a price regulated company in October, 1995. As a result of United's first proposed price changes under price regulation in 1996, a contested case was convened and assigned Docket No. 96-01423 (the "1996 case"). One of the primary issues addressed in that docket was the appropriate method of calculating price adjustments under T.C.A. 65-5-209(e). This issue was formally addressed in the January 27, 1997 Hearing Officer's Report (see Rebuttal Exhibit CSP-A to Mr. Parrott's Rebuttal Testimony; Tr. p 239-13) that read as follows: " Issue 1. How is the maximum annual adjustment, permitted under T.C.A. Section 65-5-209(e), calculated?".

Following extensive formal and informal meetings, all of the parties to the proceeding, including most notably the CAD, agreed to a Stipulation regarding the appropriate methodology to apply to price adjustments under T.C.A. Section 65-5-209(e). (See Exhibit CSP-1 to the Direct Prefiled Testimony of Steve Parrott, Tr. p 93-14). The Authority has approved the use of this agreed to methodology in two separate orders pertaining to United (Tr. pp 93-31, 93-50). This agreed to methodology is herein called the Approved Methodology.

The Hearing Officer's Report in the 1996 case, at page 4, describes in detail the process used in arriving at this agreement, including the agreement that Dr. Klein of the Authority's Staff should act as consultant, Dr. Klein's report back to the Hearing Officer of the results of the meetings and the parties'

agreement, the polling by the Hearing Officer on the record of each party to confirm their express consent to the Stipulation and Approved Methodology, and the grant by the Hearing Officer of the opportunity for the CAD to withdraw from the agreement, which the CAD did not do. Thus the CAD's agreement to the Stipulation and Approved Methodology and subsequent failure to withdraw from the Stipulation clearly show that the CAD supports the Stipulation that was the basis for the 1998 filing. Mr. Buckner, the CAD's witness, testified that although the CAD appealed a portion of the Authority's Order in the 1996 price regulation case, there was no court appeal of the issue on determining the annual adjustment under the Approved Methodology (Tr. 226). Mr. Buckner, witness for the CAD, expressly acknowledged on cross examination that the Approved Methodology did not conflict with the statute (Tr. p 214). The Authority has reconfirmed the use of the Approved Methodology in two separate orders pertaining to United and in one order pertaining to BellSouth (Tr. pp 93-31, 93-50).

As United witness Steve Parrott testified, the primary purpose of the parties' negotiations was to flesh out the meaning of the aggregate revenues test as set forth in the statute (Tr. p 115). In his words, "The problem that led us to develop the stipulated methodology was, when you look at Section 65-5-209(e) of the Code, it refers to an aggregate revenues test, but it doesn't tell you which aggregate revenues to use, and so the reason for the methodology was to set out how you perform that aggregate revenue test." (Tr. p 106).

The resulting written Approved Methodology was in fact applied by United in the instant proceeding. Mr. Parrott testified at length, using charts and handouts, and showed how each number in United's filing was determined (Tr. pp 79-91). He walked through the manner in which the inflation index (price regulation index or "PRI") was determined and how the aggregate revenues calculation (service price index or "SPI") was determined. He cited the exact paragraph reference in the Approved Methodology which United used in making each calculation and he cross-referenced each methodology reference to the actual data in United's filing which supported the calculation.

With respect to the PRI or inflation index, Mr. Parrott went through the four steps set forth in the Methodology necessary to make the calculation. The CAD attempted to discredit the manner in which step 4 of the PRI calculation was done by United. The CAD asserted that since the attachment to the Methodology calculating the PRI for 1996 showed the step 3 amount was multiplied by 100, then all subsequent step 3 amounts used in determining the PRI for future years were to be multiplied by 100. This position is erroneous for a number of reasons.

To always multiply the resulting step 3 amount by 100 would make step 3 meaningless (Tr. p 101). All that step 3 does is divide the step 2 amount by 100. To then always multiply by 100, as asserted by the CAD, merely reverses the step 3 calculation. Step 4 can be meaningful only if their is a reason for the step four number to be something other than 100.

The Methodology, in Section III (C), states that "The PRI, as of the effective date of the plan, is 100." It is for this reason only (showing how to calculate the initial 1996 PRI) that the number 100 appears in step 4 in the Attachment to the Methodology.

The CAD's position is further shown to be incorrect since Section III (C) of the Methodology goes on to state that "The PRI for subsequent years shall be calculated as described in IV (B)". Section IV (B) of the Methodology states that "The Price Regulation Index is calculated annually as... [the step 3 amount] multiplied by the **then current** value for the PRI for the company." (Emphasis added) Again, it is meaningless for the Methodology to use the phrase "the then current value" if the intent was to only use 100 as the value. Clearly the intent was otherwise. And just as clearly the purpose was to allow the PRI to cumulate, that is, to vary from year to year, depending on the amount of inflation experienced in the preceding years. Only this analysis of the Methodology makes sense.

Even the CAD's own witness, Mr. Buckner, admitted that he agreed with the Company's calculation of PRI (Tr. p 217) .

The Company's calculation is further supported by the fact that the Methodology, when describing the calculation of the aggregate revenues or SPI, uses the expression "cumulative annual percentage change... since the effective date of price regulation". [(Tr. p 93-23; Methodology Section III (D)]. Again, it would be meaningless for one part of the formula (the SPI aggregate revenues)

to require cumulation, and then argue that the inflation index that the SPI is compared to should not be cumulative.

In addition, it should be noted that the statute itself does not mandate that annual adjustments under T.C.A. Section 65-5-209(e) must be taken in any particular year. Subsection (e) states the "company **may** adjust its rates", a term of discretion rather than obligation (Tr. pp 120, 131, 132). In the very same section, in subsection (f), the legislature made it clear that with respect to increases in basic residential rates after the four year price freeze, any increases allowed by the inflation index must be taken in that year. This section reads:

> "(f) ... At the expiration of the four-year period, an incumbent local exchange telephone company is permitted to adjust annually its rates for basic local exchange telephone services in accordance with the method set forth in subsection (e) **provided that in no event shall the rate for residential basic local exchange telephone service be increased in any one (1) year by more than the change in inflation**...from the preceding year." Emphasis added.

From the above it is obvious the legislature knew how to state with clarity that rate increases could not exceed that year's change in inflation (Tr. pp 121, 122) and did so for basic residential services. If the legislature had intended to, it could just as easily have clearly restricted other inflation-based changes to the change in inflation occurring within the year. However, the legislature did not do so for those adjustments permitted under subsection (e). Thus the statute is shown to permit cumulative changes for subsection (e) adjustments.

Furthermore, from a policy perspective, the CAD's position is even more untenable. He urges the Authority to adopt the CAD's interpretation that the Methodology does not permit cumulative changes, but instead requires that all increases must be taken immediately. This "use it or lose it" position is not supported by the language in the statute or by the agreed upon Approved Methodology. Allowing a company to defer a permitted increase to a later time must be considered a benefit to consumers since price adjustments are prospective only (Tr. p 192). Consumers receive a delay in the timing of the increase and thus they experience lower rates for the entire period of time the Company defers the increase. Although the CAD asserted such a deferral could possibly have anti-competitive effects, Mr. Parrott refuted this supposition as follows. First, United is a price regulated company and must adhere to a price floor (Tr. p 193; T.C.A. Section 65-5-208(c)); second, there are anti-discrimination and other safeguards within the statute with which United must comply (Tr. p 198; T.C.A. Section 65-5-208(c); and third and most importantly, any competitor, acting as a reseller, could obtain any United service at a wholesale discount from United's retail price. Thus, regardless of the price United may seek to charge, the reseller could obtain that identical service from United at a current discount of at least 12% off of United's retail price. Quite simply, it is unrealistic to think that by deferring an increase, United could act anti-competitively in any meaningful way as asserted by the CAD.

In addition, the use of cumulative price adjustments dispenses with the need to speculate regarding what the amount of possible stimulation or suppression in revenues may arise from a proposed rate change (Tr. pp 108, 110, 111). By avoiding this guesswork, the need for a contested case proceeding is greatly diminished. This is particularly significant since there can be a multitude of proposed price changes in any given year, so long as they are revenue neutral. If each such proposed increase were to require a prediction of suppression or stimulation in revenues, the Authority could become inundated with unnecessary contested case proceedings.

Further, by using cumulative adjustments which always compare most recent year historical prices to fixed base year (June 1995) prices, the process becomes self-correcting. That is, the effect on revenues of the amount, degree, mix, period of time and number of price changes is automatically taken into account because actual, historical, unmanipulated data is in fact compared for both the base year and the current year.

As to the CAD's assertions, every point was rebutted. First, Mr. Buckner admitted that he was unfamiliar with the Stipulation and the position he was advocating was merely his "interpretation" (Tr. p 214, 215). His testimony expressly stated that it was **his assumption** that rates must be increased the maximum amount each year in order to determine the maximum cumulative increase over a period of years. (Tr. p 203-5). Second, Mr. Buckner stated that his testimony was based upon his Exhibits that used only hypothetical data

(Tr. p 219). These Exhibits did not include any of United's 1998 price regulation data which is the subject of this proceeding (Tr. pp 212, 218, 219, 222). Third, Mr. Buckner admitted on cross-examination that his assumptions were not in accordance with the Approved Methodology (Tr. p 231). Fourth, Mr. Buckner also agreed that the CAD submitted no facts as to the proper SPI calculation (Tr. p 220).

As noted earlier, the CAD in fact agreed with the company's calculation of the PRI (Tr. p 217). In sum, the CAD presented no credible evidence to rebut any part of United's filing.

ISSUE 2: WHETHER THE DIRECTORY ADVERTISING REVENUES SHOULD BE INCLUDED IN THE AGGREGATE REVENUES USED TO EVALUATE CHANGES IN RATES, OR WHETHER SUCH REVENUES CAN BE EXCLUDED

The CAD alleged that United's treatment of directory "revenues" was incorrect in two ways. One, that United failed to include imputed directory income of an affiliate in the 1998 filing, and two, that the Company improperly accounted for a decrease in contract revenues.

A. Imputed Directory Earnings.

As to the first issue, the CAD contended that United failed to include approximately $2.9 million in imputed directory Yellow Page income in its filing and such imputation was required by law. However, on cross examination, CAD witness Buckner acknowledged that imputed earnings (income) was a rate of return concept (Tr. p 205-206). He further acknowledged that earnings and revenues do not mean the same thing at all, and that United is no longer rate

of return regulated but in fact its rates are based on changes in aggregate revenues. Since the concept of imputation is based on the inclusion of income from another company, the CAD's position is theoretically inconsistent with price regulation.

In addition, Mr. Buckner was unable to cite any legal basis, either in the statute or the Methodology, for the CAD's proposition that a price regulated company must somehow incorporate earnings (income) amounts from the operations of an affiliate (Tr. p 208). Thus the CAD offered no evidence to support its wish to utilize a rate of return process for a price regulated company.

Company witness Parrott, on rebuttal, explained in detail why the CAD's position was absurd. Mr. Parrott noted that Mr. Buckner confused the issue of imputed Yellow Page earnings (income) in his direct testimony with the issue of contracted directory revenues (which is for billing and collection services, listing fees and publishing/base fees) which United receives through its relationship with other publishing companies that can be affiliates or nonaffiliates.

Imputation of Yellow Page earnings was appropriate at the time United first entered price regulation in October 1995. Initially this was consistent with and required in order to meet the statutory audit test (T.C.A. Section 65-5-209 (c)) for looking at United's earnings. In United's March, 1995 3.01 report, there was some $2.9 million dollars of imputed Yellow Page earnings. At that time the Tennessee Public Service Commission ("Commission") and the

Commission's staff performed an audit, in compliance with statutory requirements, and determined that United's June 6, 1995 rates were affordable. Embodied within those June 1995 rates were the $2.9 million dollars of imputed Yellow Page earnings. Those earnings have never been removed from United's initial rates, and the benefits are embodied in United's rates today. United has never sought to remove the $2.9 million dollars in imputed Yellow Page earnings nor did it ever seek to recover that amount from its consumers. The CAD's implication that United may have hurt consumers in Northeast Tennessee through its treatment of Yellow Page earnings was not a correct statement.

Furthermore, not only is that benefit still embodied in the rates that United has today, T.C.A. Section 65-5-209(e) provides that affordability is maintained by capping rates based on an inflation-based formula, over a period of time, using an aggregate revenues test. The Approved Methodology was set forth to do just that. Issue one, supra, in the 1996 docket was how is the cap calculated as set forth in the statute, and United has made its calculations consistent with that determination. Contrary to the CAD's assertion, neither state law nor the Approved Methodology even remotely indicates that earnings (income) must be imputed. In addition to the $2.9 million in imputed earnings contained in United's existing rates, the CAD contends United must also determine from another company the amount of growth in that company's earnings and somehow consider that earnings amount in United's aggregate revenues in order to maintain affordability under the price regulation statute.

This is likewise nowhere contained in the statute or in the Approved Methodology.

B. Change in Directory Publishing Contract

As to contracted directory revenues, United had about $3.4 million dollars in publishing fee revenues contained in that March 1995 3.01 report, and the benefits of that amount are also embodied in the rates that United has in effect today. These revenues were in the June 6, 1995 rates that were deemed initially affordable. By adhering to the Approved Methodology, United has insured that the benefit of the publishing fee revenues has continued to be passed on to customers and rates have remained affordable by United's compliance with the inflation-based formula.

As noted earlier, directory compensation, as addressed in the Approved Methodology in Section III (F), included billing and collection services, listing fee charges and the publishing/base fee amount. At the hearing an issue was raised regarding the change in the listing fee in the contract with its affiliate. Mr. Parrott noted that the fee was amended to remove potential discriminatory prices between any purchasers of listings from United, whether the listings were for a white page listing or a data base (Tr. p 154-155). All purchasers would be required to pay the same TELRIC determined amount of 4 cents per listing, whether the purchase was from a competitive CLEC under an interconnection agreement, a competing directory publishing company purchasing listings under a license agreement, or an affiliate purchasing listings under a publishing agreement with the company. Copies of these

agreements were provided as Late Filed Exhibit 2 which established that all purchasers paid the identical fee for listings.

United witness Parrott acknowledged that the October 1998 filing removed the effects of the reduction in base fee contract revenues from the September filing because of a contract change effective July 1, 1997 (Tr. p 134-135). United amended the September filing as a matter of interest to the public in that the removal would not harm anyone and in fact the net result of the amendment was to reduce by $1.3 million the amount of United's proposed increase. In other words, United sought a much smaller amount in rate increases.

The CAD appeared to object to this amendment on the ground that the October filing was not identical to the procedure followed by United in its 1996 and 1997 filings. United, in response, stated that the filing was consistent with the Approved Methodology (Tr. p 134). In addition, on five different occasions, Mr. Parrott agreed to refile (or use the September filing) and reflect the same base year contract revenues in the same manner as in the prior filings. Ironically, this would result in United's being eligible for an additional $3.8 million in increased revenues. To avoid this result, Mr. Parrott committed that the Company would not utilize the additional pricing capability arising from the contract changes related to publishing fees (Tr. pp 147, 150, 163, 165, 168). Therefore, United pointed out that it made much more sense to utilize the October filing which resulted in the same net effect, but without having the

possibility of confusion in future years (Tr. p 168). United again represents to the Authority that either approach is acceptable to United.

ISSUE 3: PAYPHONE SUBSIDY: DOES THE 1996 TELECOMMUNICATIONS ACT, SECTION 276(B)(1)(b), AND THE FCC'S ORDERS REGARDING THE REMOVAL OF PAY TELEPHONE SUBSIDIES IN DOCKET 96-128 AFFECT THE PRICE CAP ANNUAL INDEX AND THE REVENUES

The CAD asserted that United failed to comply with Federal law, specifically the 1996 Telecommunications Act, Section 276(b)(1)(B), and the FCC's orders in FCC Docket 96-128 regarding removal of pay telephone subsidies. The CAD's position is that the federal law and FCC action have, in effect, preempted the Approved Methodology since the Methodology requires United's base revenues for 1995 used in calculating the SPI to continue to reflect the 1995 level of access charge revenues.

Section 276 (b)(1)(B) the 1996 Telecommunications Act requires that companies:

> "(B) discontinue the intrastate and interstate carrier access charge payphone service elements and payments in effect on such date of enactment, and all intrastate and interstate payphone subsidies from basic exchange and exchange access revenues, in favor of a compensation plan as specified in subparagraph (A)"

In compliance with Section 276(b)(1)(B) and FCC orders in Docket 96-128, United quantified the estimated amount of payphone subsidy, the total amount of which was removed from exchange access revenues. United filed tariffs effective on May 19, 1997 which reduced intrastate switched access rates (originating CCLC) for the amount of the payphone subsidy pending the outcome of TRA Docket No. 97-00409 styled *Tariff Filings Regarding the*

Reclassification of Pay Telephone Service As Required By FCC Docket 96-128 (the " TRA Payphone Proceeding").

While access reductions resulting from the elimination of pay telephone subsidies have been tentatively approved, such amounts are not final but are in fact specifically subject to the outcome of the TRA Payphone Proceeding contested case (Tr. p 247; See also Transcript of the March 9, 1999 prehearing conference, pages 41-42; and page 3 of the Authority's May 2, 1997 Order in Docket No. 97-00409).

A TRA Staff memo to the Directors dated May 27, 1997 (Attachment D to CAD witness Buckner's prefiled Direct Testimony, Tr. p 203-16) indicates that based on a revised cost study filed by United, the Company would later file revised tariffs to reflect the change in rates resulting from a decrease in its revised subsidy calculation. With the adjustment to the subsidy amount being small and the rates presently on file being subject to further revision as a result of the pending TRA Payphone Proceeding, United did not believe it was beneficial to refile tariffs which reflect such a minor change. Further, the current rates are more favorable to interexchange carriers than the new rates would be under revised tariffs. The TRA Staff memo dated May 27, 1997 indicated that the "Staff reviewed this estimated amount, but has not audited the number because this matter will be addressed in the pending Payphone Docket 97-00409." It is unquestioned that the amount of the subsidy is not yet finally determined. The foregoing shows that United has complied with the

requirements of the 1996 Telecommunications Act, Section 276(b)(1)(B) and FCC orders in Docket 96-128 in accordance with the direction of the TRA.

In order to make adjustments to the State price cap plan and initial rates as proposed by the CAD, the Authority must conclude that federal law preempts Tennessee law. Neither Section 276 of the Federal Act nor any FCC order specifically addresses the affect on state price cap plans or specifies any mathematical calculations. Section 276(b)(1)(B), quoted above, addresses removal of subsidies from intrastate basic exchange and exchange access revenues. United has complied, in accordance with the status in the TRA's docket on this issue, by removing the total subsidy amount (subject to further TRA action) from the intrastate exchange access revenues.

The Federal Act does address preemption. Section 276 (c) of the Federal Act states:

> "STATE PREEMPTION - To the extent that any State requirements are inconsistent with the Commission's regulations, the Commission's regulations on such matters shall preempt such State requirements."

United would note that this language is specifically within "Section 276. Provision of Payphone Service". Therefore, this language is very specific to preemption of state requirements on payphone service, not a broad statement as to preemption of all state requirements. In addition, preemption is generally interpreted in its narrowest context by federal courts in view of the nature of preemption which is the intrusion into the State's jurisdiction of what is otherwise a matter of State concern. Based on the foregoing, United contends

that federal law does not preempt the Tennessee law regarding intrastate price regulation.

State law is very specific as to establishment of initial rates, and has specifically limited the adjustment of initial rates to the results of the universal service proceeding, not the TRA Payphone Proceeding. Tennessee's Price Regulation statute, in Section 65-5-209 (c) states:

> "Rates established pursuant to the above process [Form 3.01 rate of return audit] shall be the initial rates on which a price regulation plan is based, subject to such further adjustment as may be made by the authority pursuant to § 65-5-207."

T.C.A. Section 65-5-207 contains the provisions regarding universal service. This statute has only this one reference to the alteration of initial rates, and that alteration is specifically limited to the universal service proceedings under Section 65-5-207. The statute nowhere else provides for an adjustment of initial rates.

Clearly, United has complied with the removal of payphone subsidies consistent with the status of the TRA docket on this issue. By complying with the removal of payphone subsidies and maintaining United's initial rates at the June, 1995 level, United has appropriately calculated the effect of the removal of payphone subsidies in its 1998 Annual Price Cap filing.

CONCLUSION

United's filing complies in all respects with the Approved Methodology and its October filing should be approved in its entirety.

Respectfully submitted,
UNITED TELEPHONE-SOUTHEAST, INC.

By James B Wright
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June 28, 1999

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