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ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into a) whether the FCC Part 32, Uniform System of Accounts for Telephone Companies (USOA) should be adopted for telephone companies subject to the Commission's jurisdiction, b) the effect on intrastate rates if all or any portion of the USOA is adopted and c) the ratemaking treatment of the implementation cost associated with the USOA.	I.87-02-023 (Filed February 11, 1987)

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C. Hayden Ames, Attorney at Law, for Chickering & Gregory; John J. Gibbons, for himself; and Octavio Lee, for the State of California, Board of Equalization; interested parties.

Catherine A. Johnson, Attorney at Law, and Thomas Lew and Kevin P. Coughlan, for the Division of Ratepayer Advocates.

INTERIM OPINION

I. Background

On February 11, 1987, the Commission issued an order instituting investigation (investigation) to determine the Federal Communications Commission's (FCC) Part 32, Uniform System of Accounts for Telephone Companies (USOA) should be adopted for telephone companies subject to the Commission's jurisdiction.

Currently, telephone corporations under our jurisdiction are required to follow the FCC's USOA implemented in 1935 and as amended by the FCC and adopted by this Commission with certain exceptions. One such exception occurred in 1965 (Decision (D.) 68534, 64 Cal. P.U.C. 27 (1965)) when we chose not to adopt the FCC's deferred accounting for investment tax credits. However, in general, the FCC's USOA has been adopted because of our desire to simplify and coordinate the accounting and reporting requirements imposed on those telephone companies operating under the jurisdiction of both this Commission and the FCC.

The FCC issued Part 32 because it believes that the present USOA is archaic and incapable of providing for changes in a complex, competitive, technological, and economic environment.

Part 32, to be effective January 1, 1988 for telephone companies under the FCC jurisdiction, reflects a financial based accounting system to facilitate the monitoring of revenues, expenses, and investments by product, service, purpose and type; facilitate management reporting data for cost of service and the separations and settlement process; and to accommodate generally accepted accounting principles (GAAP) to permit a closer alignment with business which is not regulated.

Our investigation identified the following six issues to be addressed in the proceeding:

a. Percentage of California telephone utility operations intrastate, subject to this Commission, and percentage interstate, subject to the FCC.

b. Whether Public Utilities (PU) Code § 793 requires the Commission to adopt the FCC's Part 32.

c. Identification and quantification of implementation costs and who should bear the burden of those costs.

d. If adopted either in whole or in part should any modifications be required for intrastate purposes.

e. Effects on financial reporting, separations, and revenue requirements from adoption of Part 32 either in whole or in part.

f. Identification and analysis of other provisions of Part 32 which may affect California ratemaking policies.

A prehearing conference was held before Administrative Law Judge (ALJ) Galvin on March 17, 1987. Respondent telephone utilities agreed to file their response to issues a, b, and c by April 3, 1987. At the request of respondents and interested parties, informal workshops were scheduled to determine areas of agreement among respondents and interested parties, and to reduce the amount of time needed for formal hearings. Workshops, set for May 11, 12, and 19 through 22, 1987, were moderated by the Commission Advisory and Compliance Division (CACD), formerly the Evaluation and Compliance Division. However, parties to the investigation were unable to reach any consensus. ✓

Evidentiary hearings were held during the months of August and October of 1987. Testimony was received from approximately two dozen witnesses representing respondents and interested parties. Thirty-six exhibits were received into evidence.

Concurrent briefs on all issues except for the accounting and reporting of pension expense, tax normalization, cost allocation manual, and a legal argument on the adoption of the FCC's new separations manual (Part 36) were filed on September 10, 1987. Concurrent briefs on the remaining issues were filed on October 30, 1987.

All issues except for the accounting and reporting of pension expense are considered in this opinion. This is because of the substantial amount of testimony received on Financial Accounting Standards Board (FASB) 87 and the substantial amount of discussion in interested parties October 30, 1987 briefs on this matter. A subsequent opinion, expected to be issued in January 1988, will address FASB 87.

Full adoption of Part 32 and Part 36 is estimated to result in additional revenue requirements for the telephone utilities in the short-term. This additional revenue requirement is to be reduced gradually and after about seven years should result in a revenue requirement savings because of the shift of costs from utility plant to operating expense.

Although nominal impacts are estimated for Roseville Telephone Company (Roseville) and the smaller independent telephone companies there are some significant impacts on the larger telephone utilities for 1988. Pacific Bell estimates an additional revenue requirement of $82 million in 1988 assuming the adoption of tax normalization and application of GAAP to embedded leasehold improvements, General Telephone Company of California (GenTel) $66 million on a total company basis and approximately $46 million intrastate (exclusive of settlement effects), AT&T Communications of California (AT&T) and Citizens Utilities Company of California (Citizens) $2 million, and Continental Telephone Company of California (ConTel) $1 million.

The Division of Ratepayer Advocates (DRA), formerly the Public Staff Division, acknowledges that additional revenue requirements will occur with the adoption of Part 32's capital to expense shift and GAAP. However, DRA's witnesses have not examined the reasonableness of the utilities' estimates. DRA represents that it has been unable to determine the reasonableness of the utilities' estimates because of continuous revisions of estimates by utilities.

II. Intrastate Operations

The first issue in the investigation requires a determination of the percentage of California telephone utility operations that is intrastate, subject to our regulation. Respondent utilities' filings show that their intrastate operations, except for AT&T, are approximately 80% and their interstate operations are approximately 20%, based on the current separations procedures. AT&T's intrastate operations are approximately 60% and interstate operations are approximately 40%. No projection of intrastate operations under the new separations manual were provided because of ongoing modifications by the FCC. However, the intrastate factor is not expected to be changed materially by the new separations manual.

III. Public Utilities Code Section 793

The second issue to be addressed in this investigation is to determine if PU Code § 793 requires the Commission to adopt the FCC's Part 32. This section of the code states that the system of accounts and the forms of accounts, records, and memoranda prescribed by the Commission for corporations subject to the regulatory authority of the United States, shall not be inconsistent with the system and forms established for such corporations by or under the authority of the United States. Nothing in this section or § 794 affects the power of the Commission to prescribe forms of accounts, records, and memoranda covering information in addition to that required at the federal level.

Parties to this investigation unanimously agree that Part 32 should be adopted; therefore, this issue should be moot. However, the DRA's recommendation that the utilities be required to maintain supplemental accounting records, such as memoranda or side records for interest during construction and gains or losses on the early extinguishment of debt, is of concern to the respondent utilities.

The small independent telephone utilities are concerned that the supplemental accounting record proposal may require utilities to maintain two separate sets of accounting records. Even though Pacific Bell acknowledges that it can continue, as is does presently, to provide such additional records to the extent that the required information is available within its primary set of accounting records, Pacific Bell is concerned that DRA is seeking information which uses the present USOA structure which would require a separate set of accounting records.

A majority of this confusion stems from DRA's recommendation that respondent utilities implement a data continuity mechanism for converting new data into the old USOA accounting format to provide periodic reports. However, DRA's witness, Mirza, clarified DRA's proposal to require major utilities, consisting of Pacific Bell, GenTel, ConTel and AT&T, to have in place "a mechanism and a one-year date, most likely 1987," to restate 1987 data into Part 32 data. DRA proposes that the utilities use one of the four approaches identified in Chapter 7 of DRA's Exhibit 2.

The PU Code and General Orders already require utilities to provide specific financial data. In this instance, Mirza testified that the major utilities, except for AT&T, have agreed to provide data. They will use one of DRA's approaches but did not specify which one. Subsequently, AT&T's witness, Thiebaud, stated that with DRA's clarification of its request for data continuity, AT&T could satisfy DRA's request. Since major utilities have already agreed to provide the data requested by DRA there is no further need for the Commission to require it formally. However, should the major utilities not implement a data continuity mechanism, as agreed in this proceeding, DRA should file a petition for modification of this opinion with its concerns.

DRA also requests that the Rate Case Plan established by the Commission for a notice of intent (NOI) to file a general rate case be revised to allow DRA additional time to coordinate with the utility to understand Part 32 accounting requirements adopted by this Commission and the data continuity process discussed above.

The Rate Case Plan timetable and procedure is currently undergoing a review by the Commission in R.87-11-012 to consider effects of legislative changes which took place subsequent to the establishment of the Plan, such as PU Code § 311. Accordingly, DRA's request for modification of the Rate Case Plan timetable should be considered in the overall review and not be addressed in this investigation.

IV. Implementation Cost

Respondent utilities filed a summary of their projected cost to implement Part 32 and recommended how such costs should be recovered.

Implementation cost varied among utilities. Pacific Bell projected a $16 million implementation cost, GenTel $2 million, and the smaller independent telephone utilities under $25,000. The majority of the implementation costs consists of redesigning computer systems and related programming and staff training.

A majority of the respondent utilities recommend that costs incurred to implement Part 32 be allocated between interstate and intrastate ratepayers, similar to other legitimate costs, according to the current separations procedures. Although Citizens recommends that it be authorized to recover its implementation cost through a balancing account mechanism, GenTel does not believe that such cost should be recovered because implementation costs are virtually all 1987 expenses and recoverable through the separations process.

DRA concurs with GenTel's conclusion because the majority of the implementation costs are non-incremental, involving costs of existing staff and resources which are already recovered through current rates. To the extent that incremental costs exist, the majority of these costs will be recovered through the existing settlement process without further action by the Commission.

We concur with DRA and GenTel. Implementation costs should be recoverable in the same manner as other operating expenses, that is, through the general rate making process and settlement pools.

V. Capital to Expense Shifts

Certain indirect construction costs, comprised of approximately twenty distinct components, currently capitalized are to be expensed under Part 32. Such indirect costs include general office overheads, labor related additives, property taxes, and loss of materials and supplies associated with construction projects.

Although this accounting change will increase the utilities' revenue requirements during the initial years of implementation, a cross over point, where revenue requirement is to go negative, is estimated by DRA to occur in the mid 1990's.

Approximately seven years after implementation, this accounting change will result in a revenue requirement savings because its adoption will reduce the utilities' recorded rate base. To illustrate, adoption of this accounting change effective January, 1988 will increase Pacific Bell's revenue requirement by approximately $118 million, GenTel's by approximately $57 million, AT&T and Citizens by approximately $2 million, and ConTel by approximately $1 million in 1988. In 1993, Pacific Bell's additional revenue requirement is to be reduced by $112 million to

$6 million and GenTel's by $54 million to $3 million. Revenue requirement savings are to incur starting in 1994. The smaller telephone utilities will occur minimal or no impact from this accounting change.

Each party to this investigation, including DRA, concurs that the accounting change for indirect construction costs should be adopted for accounting and ratemaking purposes. However, they disagree over how the utilities should recover the resulting revenue requirement for ratemaking purposes.

We conclude that Part 32 capital to expense shifts to the extent they do not conflict with Commission's current ratemaking policies identified in Chapter 11 of DRA's Exhibit 2, Appendix A to this opinion, will be adopted. The method of recovery of the costs associated with this shift is discussed in a subsequent section of this decision.

VI. Generally Accepted Accounting Principles

GAAP are a common set of accounting concepts, standards, procedures and conventions which are recognized by the accounting profession as a whole and upon which most nonregulated enterprises base their external financial statements and reports.

Part 32 adopts GAAP for accounting purposes to the extent regulatory considerations permit. Future GAAP changes are to be adopted automatically, unless the FCC notifies the telephone utilities to the contrary. In those instances where GAAP permits more than one accounting method, the FCC is to select the appropriate accounting method for use by the telephone utilities.

The adopted of GAAP changes, exclusive of tax normalization discussed in a subsequent section of this opinion, will initially result in the need for additional revenue requirements for Pacific Bell and GenTel. However, the need for additional revenue requirements will decrease over the years and in approximately the seventh year will result in a revenue requirement savings.

Due to GAAP alone, Pacific Bell's 1988 additional revenue requirement, excluding the effects of tax normalization, is estimated to be $44.2 million; GenTel's is estimated to be $9 million. In 1993 Pacific Bell's revenue requirement is to be reduced by $17.5 million to $26.7 million and GenTel's by $7.4 million to $1.2 million. There are to be nominal, if any, revenue requirements changes for AT&T and the smaller independent telephone companies.

DRA recommends adoption of all the changes which have no revenue impact and adoption or modified adoption of most of the remaining FCC adopted GAAP items which have major revenue impacts. The adoption was recommended for accounting purposes only. DRA is silent on the ratemaking treatment for the additional revenue requirement caused by GAAP. However, DRA does recommend that all future GAAP promulgations be considered for accounting and ratemaking purposes on a case-by-case basis. GAAP issues identified by DRA are:

a. Interest During Construction

b. Accounting Methods

c. Leasehold Improvements

d. Compensated Absences

e. Contingent Liabilities, Workers' Compensation

f. Incentive Awards

g. Early Extinguishment of Debt

h. Computer Software Cost

i. Depreciation

j. Comprehensive Normalization

k. Future GAAP Changes

a. Interest During Construction

The FCC proposes no changes to its Interest During Construction (IDC) formula in Part 32. However, because the FCC allows short-term construction projects to be included in rate base, DRA opposes the adoption of the FCC formula in favor of the Commission's IDC formula. The Commission formula provides for the accrual of IDC on construction projects expected to be completed within one year.

GenTel recommends the FCC formula be adopted. It believes that DRA is advocating a short-sighted position because, although $9 million of GenTel's $66 million additional revenue requirement in 1988 is due to the FCC's IDC method, in the long-term (approximately seven years) GenTel will experience a revenue requirement savings. There is no impact on Pacific Bell because Pacific Bell does not seek a change in this Commission's IDC formula in this investigation.

The Commission's IDC formula is based on sound principles and has withstood litigation in several of Pacific Bell's and GenTel's rate proceedings. This investigation has produced no evidence to demonstrate that the FCC's formula is superior to the Commission's IDC formula. Therefore, the telephone utilities should continue to maintain appropriate records to conform to the Commission's IDC policy, currently applicable to construction work in progress involving expenditures of $25,000 or more.

b. Accounting Methods

As previously discussed, where GAAP permits more than one accounting method the FCC proposes to select the appropriate method for use by the telephone utilities. Other than DRA's vague statement that there may be individual instances where DRA needs additional information to review the accounting method selected by the FCC, there were no objections.

Therefore, in those instances where GAAP permits more than one accounting method the telephone utilities should follow the accounting method selected by the FCC. If the telephone utilities, DRA, or any other party objects the method selected by the FCC that party should bring the issue before the Commission in a formal proceeding (such as a general rate proceeding).

c. Leasehold Improvements

Under GAAP all leasehold improvements are capitalized separately and amortized over the term of the lease, which is generally shorter than the life of a building. Pacific Bell estimates an additional $10.1 million revenue requirement for 1988 should this GAAP provision be adopted. Part 32 is silent on the treatment of embedded leasehold improvements capitalized as a part of the buildings account and currently amortized over the life of the building.

There is no opposition to using GAAP for leasehold improvements on a prospective basis. DRA proposes that embedded leasehold improvements currently in the buildings account be amortized over the life of the buildings account. However, DRA's witness testified that DRA would reconsider its position should the FCC, currently considering amortizing embedded leasehold improvements, promulgates a specific method of amortizing the embedded accounts.

We concur with DRA. Leasehold improvements should be capitalized separately and amortized over the term of the lease. Embedded leasehold improvements should continue to be amortized on a prospective basis over the life of the buildings account.

d. Compensated Absences

GAAP requires compensated absences to be recorded as an expense in the year the liability is incurred. The embedded liability is to be amortized over ten years to ease rate shock. This is a departure from the Commission's current policy of recording compensated absences as an expense in the year the cash is actually paid out. Pacific Bell estimates this change will result in a constant additional revenue requirement of $19.2 million.

DRA does not object to the Part 32 accrual treatment of compensated absences; however, it recommends that "if a situation arises in which a utility receives cash before the cash is actually expended, this situation should be accounted for in the calculation of working cash allowed in rate base."

Since there is no opposition to the treatment of compensated absences, the telephone utilities should conform to Part 32 in accounting for compensated absences. DRA's proposed working cash treatment for cash received by a utility prior to the cash being expended should be addressed on a case-by-case basis in general rate cases.

e. <u>Contingent Liabilities, Workers' Compensation</u>

GAAP requires the expected liability for workers' compensation to be calculated and accrued as an expense in the current year. Pacific Bell estimates that adoption of this proposal would increase its 1988 revenue requirement by $5.8 million. Since Pacific Bell is the only utility which is self-insured for workers' compensation, this proposal does not currently affect the other utilities.

DRA does not oppose this treatment; however, it believes that because GAAP tends to overstate the amount of liability, Pacific Bell and any other utility using the contingent liability approach should use a mid-range estimate to record its liability.

Again, there is no opposition to the principle of applying GAAP. Therefore, the accrual basis of accounting for workers' compensation should be adopted. However, because of the need to estimate the amount of liability for workers' compensation disputes regarding the reasonableness of the liability will occur. Rather than requiring mid-range estimates, the utilities should maintain necessary documentation to support their liability.

f. Incentive Awards

GAAP requires incentive awards to be recorded on an accrual basis. The FCC did not address this matter in Part 32. DRA represents that Pacific Bell already reports incentive awards on the accrual basis of accounting.

DRA recommends that if GAAP is adopted for incentive awards, the utilities should be required to account separately for the amounts which are accrued for employees who terminate during the year. The accruals for these employees should be reversed.

We concur. GAAP should be adopted for incentive awards and any awards accruing for employees terminating service during the year and not receiving the award should be reversed.

g. Early Extinguishment of Debt

GAAP requires that gains and losses from the early extinguishment of debt be recognized in the year of occurrence. However, the Commission's generic policy has been to amortize gains and losses over the life of the replacement debt.

Other than the utilities' recommendation that GAAP be adopted, no justification to change the Commission policy has been offered. The utilities should continue to amortize gains and losses from the early extinguishment of debt over the life of the replacement debt.

h. Computer Software Costs

The costs associated with initial operating systems' software purchased for general purpose computers and certain associated right-to-use fees are to be capitalized while applications software and recurring right-to-use fee are to be expensed.

The only dispute in the accounting for software costs is in the expensing of software systems being developed internally and applications systems for future revenue-generating services. DRA's witness, Amato, recommends that such software be capitalized under a deferred accounting approach for recovery of costs when the utility actually starts offering the service, similar to the accounting for Pacific Bell's 800 service software development cost required by D.86-01-026.

Amato recommends the deferral treatment because such costs:

a. Relate to future services and deferral would allow the timing of cost recognition to coincide with revenue recognition.

b. May be incurred to develop non-regulated, competitive service offerings. If expensed immediately, ratepayers would be burdened with paying the utility for services which may never benefit them.

c. May be incurred for a system which may never become operational. If expensed immediately, ratepayers would be burdened with paying for services which the utility may never provide.

Under this proposal, costs would accumulate in a deferred account until the software systems are examined in a general rate proceeding. Those software systems used for new regulatory services would be capitalized, amortized over the system's projected life, and recoverable in rates. However, those software systems abandoned or utilized in offering an unregulated service would be recorded as a non-operating expense and not be recoverable through the rate making process, irrespective of their prudency.

Pacific Bell believes that DRA's proposal is not appropriate because new software under development for future revenue-generating services is not addressed in Part 32 and because there is no significant change to the current method of accounting for software costs. Further, the deferred method for Pacific Bell's pending 800 service was adopted only after the specific service was scrutinized by all interested parties in a Commission proceeding.

The utilities are concerned that under Amato's proposal they will bear all the risk of the development of new software and pass on all the benefits of the development to the ratepayers. This is because Amato recommends that, although a return is to accumulate with the software development cost, recovery would not occur until a new regulated service is offered and the prudency of such costs are scrutinized for reasonableness in a rate proceeding. Further, if a new regulated service is not implemented, the utilities would not be allowed to recover their development cost, no matter how prudent the costs are.

Although the telecommunications industry is in a dynamic era with the increased presence of innovative technology and competition, telephone utilities are not research or development companies. Not even Pacific Bell's software development for its proposed 800 service is being undertaken by Pacific Bell; it is being undertaken by an unregulated affiliate, Bell Communications Research, Inc.

Ratepayers should not be required to compensate utilities for software development costs intended for future revenue-generating services without a mechanism to review the intergenerational equities or the prudency of such costs. Currently, this review is conducted in general rate proceedings on a case-by-case basis as, for example, Pacific Bell's software development costs for 800 service.

As the utilities assert, Part 32 does not substantially depart from the current method of accounting for software development costs. However, DRA proposes the implementation of a blanket cost deferral until the service is being offered as a regulated service or abandoned, a retrospective review.

Part 32 does not substantially change the accounting for software costs from the current accounting procedure as shown on pages 3-9 of DRA's Exhibit 2. We will continue to address software development costs for future revenue-generating services on a case-by-case basis.

i. <u>Depreciation</u>

Part 32 affects the depreciation accrual to the extent that certain asset groups, such as computer and central office equipment - toll, will be reclassified from one depreciation category to another. This reclassification of categories will change the remaining life of the categories, the reserve balance of the existing categories and the depreciation accrual for those categories.

DRA's witness, Joshi, recommends that any revenue requirement resulting from the accrual change be charged to a deferred account until the accrual reaches a cross-over point, negating the revenue requirement. This recommendation is made even though DRA and respondent utilities project that revenue requirement changes associated with the changes to depreciation categories will be minimal.

According to DRA, any changes in depreciation would be revenue neutral until there is a represcription of depreciation rates. Such represcription is expected to take place in 1988 for Pacific Bell and 1990 for GenTel. Therefore, we conclude that rather than requiring the utilities to implement a procedure to track nominal depreciation changes that may occur in 1988 for Pacific Bell and 1990 for GenTel, such revenue requirements, if any, should be addressed during the represcription of the utilities' depreciation rates. The utilities should submit as a part of their respective represcription filing the impact of rate changes caused by depreciation changes adopted in this order.

j. <u>Comprehensive Normalization</u>

The issue of comprehensive normalization was initially raised by Pacific Bell, GenTel, and AT&T because the FCC's Part 32 requires that the tax effect of book and tax timing differences be normalized. Comprehensive normalization is an accounting concept that matches all income tax effects with the underlying transactions in the accounting period in which the transactions are reported in the utility's income statement.

Should comprehensive normalization for income taxes be adopted, Pacific Bell's and GenTel's revenue requirement would be immediately reduced by $46 million and $6 million, respectively. Five years later, in 1993, Pacific Bell's revenue requirement would be increased $3 million and GenTel's decreased by $3 million. There would be a minimal impact, if any, on AT&T and the smaller independent telephone companies.

Prior to The Tax Reform Act of 1986, construction overheads were capitalized for accounting and ratemaking purposes as components of construction-work-in-progress (CWIP). However, for accounting and ratemaking purposes these overhead components were deductible currently for federal tax purposes. The federal tax benefits derived from taking the overhead components capitalized as a deduction for federal tax purposes were flowed through to the ratepayers for ratemaking purposes. This policy resulted in a lesser ratemaking federal tax expense than what it would have been if the overheads had been considered capitalized components of CWIP for federal tax purposes and normalized.

Subsequent to the passage of The Tax Reform Act of 1986, construction overheads that were previously deductible in arriving at federal tax must now be capitalized in CWIP as a construction component for federal tax purposes.

Part 32 requires overheads previously capitalized to be expensed raising the issue of normalization versus flow-through. Under normalization, the difference between expensing overheads currently and the accelerated depreciation available for Federal tax purposes would be multiplied by the statutory corporate tax rate and reflected as a deferred tax. In other words, the company would take the deduction currently instead of capitalizing it and amortizing the deduction. Since the accounting and ratemaking treatment of overheads as expense has a greater effect on reducing taxable income than does the deduction of accelerated depreciation on a tax return basis, the deferred tax generated by this timing difference would be added to rate base.

Under flow-through, the ratemaking Federal tax expense is higher than under normalization because the current deduction of overheads for the Federal tax calculation is replaced with the accelerated depreciation available on the capitalized overheads on a tax return basis.

An ancillary issue pending before the Internal Revenue Service (IRS) is an industry wide application for a "change in accounting method." If IRS approves the request, federal tax treatment would generally be consistent with the capitalization requirements of Part 32. However, if it isn't approved, the utilities would be required to continue capitalizing for federal tax purposes the overhead components expensed under Part 32. Pacific Bell estimates an additional revenue requirement of $2 million if the accounting change for tax purposes is not approved.

The utilities recommend tax normalization because it conforms with GAAP, it results in a lower revenue requirement, and it eliminates excessive record keeping requirements. GenTel's cash flow analysis shows that its ratepayers could benefit from the adoption of normalization for the next 20 years. Although Pacific Bell's intrastate revenue requirement impact shows that Pacific Bell's ratepayers could benefit from the adoption of normalization in 1988 by $46 million, this benefit will turn around and by 1993 cost Pacific Bell's ratepayers an additional $2.7 million.

DRA recommends the continuation of flow-through because it is consistent with current Commission policy, because the Federal tax law is highly volatile with frequently changing requirements, and because normalization would only benefit the ratepayer in the short-term.

The issue of normalization versus flow-through was addressed by the Commission in D.84-05-036 (OII 24). Upon review of a comprehensive analysis of all California utilities, the decision affirmed that the flow-through treatment of timing differences is to continue as Commission policy.

Although The Tax Reform Act of 1986 substantially eliminates the tax benefits that were flowed through to the ratepayers from the overhead components previously capitalized but deductible for tax purposes, the treatment may be short lived because additional changes to the tax code are under consideration. ✓ A change in policy at this time may not be warranted because of the volatility of the recent tax changes and short-term impacts.

We concur with DRA's analysis that the Federal tax law is volatile and that normalization would only benefit the ratepayers in the short-term. A substantial amount of time and analysis went into our affirmation of a generic flow-through policy. The telephone utilities have not convinced us that the generic policy should be modified for telephone utilities. Therefore, the policy of flowing through tax benefits should continue as a generic ratemaking policy and the telephone utilities should continue, as they have in the past to maintain memorandum records reflecting the accounting for both flow-through and normalization of taxes.

k. Future GAAP

Part 32 adopts future GAAP pronoucements automatically, unless the FCC notifies the telephone utilities to the contrary. However, DRA recommends that future GAAP pronouncements should be adopted by this Commission only after the major utilities (PacBell, GenTel, AT&T, ConTel, Roseville, and Citizens) provide a positive showing to the Commission that such pronouncements are for the good of the ratepayers. To accomplish this positive showing DRA recommends that:

a. This investigation be kept open to address future GAAP changes.

b. Telephone utilities' Part 32 petitions and/or revenue requirements filed with the FCC should be filed concurrently with this Commission. Copies are to be sent to both DRA and CACD.

c. For GAAP changes, revenue impact studies are to be provided to DRA and CACD within 90 days after the FASB releases its final pronouncement.

d. For Part 32 changes initiated by the FCC, FCC required studies should be filed in accordance with item b.

e. Non-revenue items be addressed as supplements to this investigation on a periodic basis as necessary.

GenTel concurs with DRA's proposal because it believes that FASB's GAAP changes will be relatively infrequent.

We concur with DRA that future GAAP pronouncements should not be routinely adopted. However, this investigation should not be kept open for an indefinite period of time. Rather, the Commission's Resolution procedure should be used to address subsequent Part 32 changes. Should a controversial issue occur, a new investigation could be opened to consider the matter based on an evidentiary record.

The following telephone utilities, Pacific Bell, GenTel, AT&T, ConTel, and Citizens should provide the following to both DRA and CACD Directors:

a. Concurrent copies of any Part 32 petition and/or revenue requirement filed with the FCC.

b. For GAAP changes, revenue impact studies within 90 days after the FASB releases its final pronouncement.

c. For Part 32 changes initiated by the FCC, FCC required studies concurrent with their FCC filing.

Roseville should not be included because, unlike the other telephone utilities, its revenues requirement impact from adoption of Part 32 and Part 36 is nominal.

With the foregoing discussions GAAP as modified by this opinion should be adopted. Any revenue requirement impacts should be accounted for in a manner consistent with the treatment for capital to expense charges identified in this decision.

VII. Post Retirement Benefits

AT&T and ConTel recommend the adoption of a change in accounting for post retirement benefits from the cash basis of accounting to the accrual basis. Post retirement benefits will change from being recorded as an expense when actually paid to being an expense which is accrued and recorded when earned. ConTel took its recommendation one step further by adopting this accounting change for its accounting records effective 1987.

Both AT&T and ConTel recommend this change in accounting on the premise that the FASB is expected to issue an exposure draft on converting to the accrual method for post retirement benefits sometime next year. An exposure draft is a proposal for a GAAP sent out by FASB for comments by all parties prior to adoption.

DRA asserts that adoption of this accounting change by FASB is purely conjectural at this time. Even if an exposure draft is issued next year, it is not currently known what actuarial methodology may be required or accepted by the FASB. Further, once an exposure draft is issued, there is generally a lengthy period of time before the FASB issues a final pronouncement. For example, a FASB exposure draft on accounting and reporting by defined benefit pension plans issued in April 1977 was adopted nine years later.

We concur with DRA. This investigation was opened to consider whether GAAP should be adopted for accounting purposes, and if so, to what extent, not to speculate on future GAAP pronouncements. The accrual method of accounting for post retirement benefits should not be adopted at this time. Further, ConTel should change its accounting records for Commission purposes to conform with the cash basis of accounting for post retirement benefits.

VIII. Prior Ratemaking Policies

DRA, concerned that the adoption of Part 32 may have unforeseen side effects of eradicating prior Commission decisions and policies adopted over the years, recommends that if any such issue arises, it be addressed in each utility's general rate proceeding. Further, adoption of Part 32 should not be considered a reason for any telephone utility to abandon accounting and ratemaking requirements instituted by this Commission in past proceedings. To the extent that such accounting and ratemaking changes are not specifically addressed in this opinion, we concur.

In this investigation Pacific Bell and DRA have identified a prior Commission policy pertaining to the accounting for affiliated company transactions which needs to be modified because in its present form it renders compliance under Part 32 impossible.

By D.86-01-026 Pacific Bell was required to record all transactions with affiliated companies in Account 674, General Services and Licenses. Although not specifically ordered to do so, GenTel and ConTel also use Account 674 to record transactions with affiliated companies.

Under Part 32 accounting, affiliated company transactions will be disaggregated to several different Part 32 accounts based on the nature of the affiliate transactions. There will be no account similar to the current General Services and Licenses expense account. However, Pacific Bell and DRA developed a procedure to provide the Commission with the necessary information to oversee and analyze affiliated company transactions. This agreed upon procedure between Pacific Bell and DRA should be used by any telephone company involved in affiliate company transactions. However, AT&T, who maintains its accounting records on a national accounting system, should be permitted to provide affiliated company transactions on a side record basis to avoid unnecessary costs. The procedure is as follows:

a. For each Part 32 account to which affiliate costs are assigned, a separate and unique subaccount code (e.g., function code, reporting code, or expenditure code) is to be set up to record the affiliate costs chargeable to that account.

b. Affiliate company subaccount codes are to be used exclusively to record affiliate company costs.

c. The cumulative total recorded in affiliate company subaccounts' codes for a period must reconcile with the affiliate company billing for that period.

d. Subsidiary records to support the monthly affiliate billings are to be set up and maintained, with such records providing an audit trial to the Part 32 account assigned affiliate costs and a year-to-date accumulation of the total costs billed by the affiliate.

e. Supplemental memorandum records are to be maintained for surveillance purposes to track Commission adopted affiliate company adjustments.

f. For rate proceddings, the utilities are to submit their test year affiliate company estimated costs separately.

IX. Separations

Telephone utilities provide both interstate and intrastate services subject to regulation by the FCC and this Commission, respectively. Therefore, it is necessary to allocate (separate) the utility's revenues, expenses, taxes, investments, and reserves between interstate and intrastate operations. This is accomplished through the use of a separations manual. For intrastate purposes this separations manual is used to determine the cost of services within the state, such as interLATA (Local Access and Transport Area) access, message toll, toll private line, and exchange service.

Currently, the FCC's Separations Manual (Part 67) is used by this Commission. However, this separations manual is structured by accounts identified in the FCC's current USOA. With the adoption of Part 32, to be effective January 1, 1988, the separations manual is obsolete. Accordingly, the FCC issued a new separations manual (Part 36) based on the new USOA, to be effective January 1, 1988.

GenTel and AT&T estimate nominal impacts from the adoption of Part 36. However, Pacific Bell initially estimated that adoption of Part 36 would result in an additional $28.6 million revenue requirement comprised of:

	Issue	Impact (Millions)
a.	Central Office Category 6	$ 5.4
b.	Central Office Category 8.23	(19.5)
c.	Revenue Accounting Expense	(23.7)
d.	Marketing Expense	62.5
e.	Other Conformance Issues	3.9
	Total Impact	$ 28.6

Part 36, in addition to conforming to Part 32, incorporates four separations rule changes. Of the four rule changes only one, the assignment of all marketing activities to the intrastate jurisdiction, has a significant impact on intrastate revenue requirements. As shown in the above tabulation, the allocation factor for marketing results in a $62.5 million revenue increase for Pacific Bell.

Although DRA's witness, Low, expresses caution in adopting the new marketing allocation factor, he does recommend adoption of Part 36 to the extent that it conforms with Part 32, as adopted in this investigation.

However, Low makes no recommendation on the revenue requirement effect of Part 36 because he has not yet analyzed separations data from the major utilities. According to Low, he needs at least 45 days to analyze Part 36 data from the major utilities before he can recommend whether the individual utility's revenue requirement is reasonable or not. Since he only received Pacific Bell's separations data in the first week of August and expected to receive ConTel's and GenTel's on August 15 and October 15, 1987, respectively, a DRA recommendation on revenue requirement impacts for Part 36 will not be available until at least January 1988.

Subsequent to the receipt of separations testimony, the FCC revised its allocation factor for marketing expenses to include access revenue, on an interim basis. The FCC is reviewing its marketing factor and intends to issue a permanent factor in April 1988. With this interim change in the marketing factor Pacific Bell's witness, Sawyer, testified that Pacific Bell's revenue requirement related to Part 36 should be reduced by $62.5 million, producing a negative $33.9 million requirement. DRA's major concern with the adoption of Part 36 is alleviated with the interim allocation factor.

During evidentiary hearings GenTel's counsel brought to the attention of all parties a recent Ninth Circuit Court of Appeals decision (Hawaiian Telephone Company v. Public Utilities Commission, 827 F.2d 1264 (9th Cir. 1987) regarding the FCC's authority to determine separations procedures. This decision is being appealed by the Hawaiian Commission. By brief, DRA confirmed that it would make any recommendations to modify the FCC's Part 36. However, DRA will review its position on modification of Part 36 after decision on the Hawaiian Commission's appeal. Meanwhile, DRA is reviewing the reasonableness of the revenue requirement impacts from adopting Part 36.

Disputes regarding the adoption of Part 36 have been resolved during the course of this investigation and all parties recommend adoption of Part 36. Therefore, we adopt Part 36.

Consistent with the treatment of capital to expense impacts Pacific Bell, GenTel, Citizens, and ConTel should record the revenue requirement impact of adopting Part 36 in a balancing account. Supporting workpapers should be maintained for review until the balancing account is terminated. AT&T, Roseville, and the smaller independent telephone companies should address the revenue requirement impacts in their next general rate case or GO 96 filing, as appropriate.

The one remaining issue, as pointed out by DRA, is the reasonableness of the individual utility's revenue requirement impact from adopting Part 36. This revenue requirement issue should be addressed during the review of the balancing account.

a. <u>SPF to SLU</u>

One of the three minor separations rule changes relate to Central Office Category 6 (Category 6). Non Traffic Sensitive (NTS) costs associated with Category 6 will no longer be distinguished from traffic sensitive costs. This change will make it impossible to continue to apply a subscriber plant factor (SPF) to the subscriber line usage (SLU) to Category 6 for the purpose of shifting NTS costs from interexchange access services to exchange services. However, SPF to SLU will continue to apply to the majority of NTS costs.

A Dial Equipment Minutes (DEM) measurement replaces the SLU measurement, both of which measure the relative use of local switching equipment. To put this in perspective, Sawyer calculated Pacific Bell's DEM and SLU interLATA access factor for March 1987. The DEM measurement shows that 6.9% of all telephone call minutes on subscriber lines are from interLATA access calls and the SLU measurement shows 6.7%, or a 0.2% differential between DEM and SLU. This differential results from the inclusion of closed end WATS minutes in the DEM formula.

Pacific Bell recommends that the Part 36 DEM measurement should be used to determine the shift from access to exchange services and that the shift amounts using DEM be included for recovery in the annual SPF to SLU advice letter filing. GenTel concurs with Pacific Bell.

Since there is no opposition to Pacific Bell's proposal, the DEM measurement should be used in place of the current SLU measurement to determine shifts from access to exchange services for Category 6, only.

X. Other Issues

The investigation identifies other proceedings that are being undertaken by the FCC concurrent with Part 32. Two of these proceedings, Part 64 (commonly known as Part X) and Part 69 are addressed by DRA. Part 64 is a cost allocation standard for recording transactions between regulated telephone utilities and their corporate affiliates. Part 69 is revised access charge rules.

a. Part 64

DRA's witness, [illegible], did not analyze the impact of Part 64 because the FCC was considering several petitions for reconsideration and because the utilities' cost allocation manuals were not yet finalized. Lew recommended that Part 64 be considered at a later date when more information and time is available. According to Lew, lack of a decision on Part 64 will not adversely affect the adoption of Part 32.

On the last day of evidentiary hearings, DRA's counsel informed all parties to the investigation that DRA is ready to proceed with Part 64 and requested that parties have their Part 64 testimony ready in December 1987. The telephone utilities objected to DRA's request because they believed that Part 64 is not a part of this investigation. The matter was deferred to briefs due on October 30, 1987.

DRA, concerned that the FCC has set January 1, 1988 to be the effective date of Part 64 for interstate purposes, recommends that the Commission address Part 64 by the end of 1987. According to DRA, it considered Part 64 to be an issue in this proceeding and believes that it should be considered with Part 32.

The utilities do not believe that it should be addressed in this investigation. Although Part 64 is identified in the investigation, similar to Part 69, it is only identified as one of the many changes occurring in the FCC rules. GenTel and the independent telephone companies also point out that the Commission does not currently have an official method of accounting for the allocation of costs between utilities and their subsidiaries.

This investigation was opened to specifically address Part 32, its effect on intrastate rates, and the rateking treatment of the implementation costs associated with Part 32. DRA's own witness testified that lack of a decision on Part 64 will not affect the adoption of Part 32.

Part 64 is not specifically identified as an issue in this investigation. Further, the investigation is not intended as a "catch-all" to address ancillary matters. To keep it open at this time would require us to expand the investigation and to notify prospective interested parties of our intentions. We conclude that Part 64 should not be addressed in this investigation.

However, since the Commission currently does not have a method for utilities to allocate costs between regulated telephone utilities and their corporate affiliates, it may best to institute a proceeding to consider the FCC's Part 64. Such a proceeding should be considered by CACD and if warranted, proposed to us in a new investigation.

b. Part 69

Part 69 is another ancillary matter discussed by DRA. However, in this instance DRA believes that because Part 69 is not intended to have an impact on intrastate ratemaking under current conditions, it need not be addressed. However, DRA does recommend that Part 69 be reviewed after the FCC issues its final report and order to verify that it will not affect intrastate ratemaking. Part 69 should not be considered at this time.

XI. Impacts

The adoption of Part 32 and Part 36 with modification will have the largest revenue requirement impact on Pacific Bell, GelTel, AT&T, Citizens, and ConTel. Based on incomplete estimates of the utilities which have not been examined, Pacific Bell will incur an additional revenue requirement of approximately $118 million in 1988, GelTel $46 million, AT&T and Citizens $2 million, and ConTel $1 million. The approximate impact on Pacific Bell and GelTel as a result of this decision are set out below:

Item	Pacific Bell	GenTel
	(Millions of Dollars)	
Capital to Expense Shifts	$ 118	$ 46
GAAP Shifts		
Compensated Absences	19	NA
Workers' Compensation	6	NA
Incentive Awards	9	NA
Separations	(34)	NA
Total	$ 118	$ 46

(NA = Not Available)

We stress that these figures are preliminary and are based on the estimates furnished by Pacific Bell and GenTel.

XIII. Balancing Account

The next issue we need to address is the method utilities should use to recover the revenue requirement impacts caused by the adoption of Part 32 and Part 36.

DRA does not believe that current ratepayers should be required to compensate the utilities for the capital to expense accounting change because the utilities will not incur any additional out of pocket cost; they will incur only "paper" costs. Further, DRA contends that it is future ratepayers who are to benefit from the resulting decrease in revenue requirement.

DRA proposes that the additional revenue required from this accounting change be charged to a deferred account on a yearly basis until a cross-over point is reached and the revenue requirement from the capital to expense shift becomes negative. The surplus received should then be offset against the accumulated balance until the deferred account reaches zero. Concurrently, DRA proposes that the telephone utilities should be required to maintain subsidiary records so DRA could analyze the activity related to each individual capital to expense shift during the period when the deferred account is needed. DRA's witness, Woods, recommends that the smaller independent telephone utilities be exempt from using a deferred account because their additional revenue requirement associated with this accounting change are nominal.

DRA's witness recommends that a deferred account be implemented using existing utility estimates of the capital to expense shifts rather than actual dollar amounts because the utilities would have difficulty in identifying and tracking the changes without maintaining a complete separate set of records. These estimates are to be audited by DRA on a yearly basis, prior to the utilities recording their estimates in the deferred account. The authorized rate of return will be applicable to the accumulated balance of the deferred account, resulting in a recovery mechanism similar to rate base.

The utilities object to DRA's proposal because it requires the utilities to estimate and maintain subsidiary records showing the development of approximately twenty individual capital to expense items and requires the utilities to estimate and document yearly rates of growth or decline, associated depreciation rates, construction expenditures, wage escalation factors, rate of return, and net-to-gross multipliers for at least twenty years.

We do not believe the utilities should be committed to such a long-term recovery of cost. Such a procedure would not only result in additional cost on the part of the utilities and additional auditing work for DRA but could result in disputes and in lengthy proceedings regarding the detail of subsidiary records, assumptions utilized, and inconsistent treatment among utilities.

Not only would the utilities be required to maintain a detailed set of records for approximately twenty years, the total cost to the ratepayers and the time lag before the deferred account is depleted would more than double the amortization period because of the imputation of a return to be accumulated deferred account balance. We concur with the utilities objections to DRA's proposal and we will not adopt it.

Pacific Bell, Citizens, and ConTel propose that a balancing account mechanism be adopted. They believe that such a mechanism is equitable to both present and future ratepayers, and to the utilities, while avoiding a dramatic increase in the record keeping burden and expense of the utility. Under this proposal, the revenue requirement impacts of this accounting change and other impacts from this investigation are to be placed into a balancing account with the impacts of other current proceedings, such as the Tax OII (I.86-11-019) and the triennial represcription.

The balancing account concept has merit and should be considered. However, there is one important factor which the parties appear to have overlooked. That is, the balancing account proposal assumes a guaranteed recovery of cost.

Historically, this Commission sets rates which provide utilities an opportunity to recover their costs and to earn a fair return on their investment; utilities are not, as parties propose in this instance, guaranteed recovery of costs. If the telephone utilities implement a new maintenance program designed to reduce future maintenance costs, such costs would be recoverable through the traditional trending procedures used for ratemaking purposes. Adoption of a change in accounting should not be treated any differently.

However, we recognize that the changes occasioned by our adoption of Parts 32 and 36 are substantial and at this point the utilities' and DRA's estimates of the revenue requirement effects of these changes is necessarily preliminary. We will therefore establish a balancing account for those utilities which have substantial revenue requirement impacts: Pacific Bell, GenTel, Citizens, and ConTel. The balancing account will be established for a limited period of time, not to exceed one year, and it will bear interest at the 90-day commercial paper rate consistent with our other balancing accounts.

This procedures will provide a temporary vehicle to isolate the effects of the USOA changes for DRA to examine and assess the reasonableness of the utilities' estimates of the revenue requirement impacts. For that reason, the balancing account should be separate from any other balancing account the Commission may authorize and should only include revenues and expenses resulting from the USOA changes adopted in this decision.

We expect to terminate this balancing account and to place the account balances in rates (along with other revenue requirement changes resulting from the Tax Reform Act of 1986, the inside wiring investigation, Pacific Bell's 1988 attrition and General Telephone's final decision in its general rate case) not later than January 1, 1989 and quite possibly sooner, in conjunction with our decisions in our investigation into rate flexibility, I.87-11-033 instituted on November 25, 1987. We will issue further orders disposing of the balancing account in that proceeding.

Those utilities implementing a balancing account should file a summary of their balancing account as of February 29, 1988 in original and 12 copies with the Commission's Docket Office on or before March 31, 1988. Concurrently, copies of the filing should be mailed to all parties to this proceeding and detailed supporting workpapers should be provided to DRA. The utilities should provide copies of the detailed supporting workpapers to all other parties requesting such documentation.

A report on the reasonableness of the individual utility's balancing account should be filed with the Commission's Docket Office by DRA and any other interested party. The utilities' revenue requirement estimates and methodology for developing these estimates have been available to all parties, at least since the filing of prepared testimony in July of 1987.

Therefore, thirty days should be more than sufficient time for DRA and other interested parties to review and to comment on the utilities' balancing account filing. DRA and other interested parties should file its balancing account reasonableness report with the Docket Office, and serve copies on all parties of record, on or before May 2, 1988. The reasonableness report should identify any issues to the utilities' balancing account filing. This report should (by issue) explain the issue, identify the monetary impact, recommend an alternative method, explain why the alternative method should be used, and identify the monetary impact of the alternative method.

Rather than establishing a procedure to address balancing account issues on speculation that issues will exist, the assigned Commissioner to this investigation will determine the procedural method, if necessary, to address balancing account issues.

GenTel proposes that it be allowed to recover its increased revenue requirement through its pending rate proceeding, Application (A.) 87-01-002. However, because all the revenue requirement impacts have not been quantified and scrutinized by DRA or other interested parties such a proposal should not be adopted at this time.

Since AT&T, Roseville, and the smaller independent telephone companies will incur minimal revenue requirement impacts, such impacts should be addressed in their next general rate case or General Order (GO) 96 filing as appropriate.

XIII. Section 311 Comments

Pursuant to the Commission's Rules of Practice and Procedure, the ALJ's proposed decision on this matter was filed with the Docket Office on November 20, 1987, and mailed to all interested parties of record.

The ALJ received comments filed by Pacific Bell, GelTel, AT&T, Citizens, Roseville, and DRA on December 10, 1987 and received reply comments filed by Pacific Bell and DRA on December 15, 1987. The comment, discussing clarification of specific matters, to the extent adopted were included in the appropriate place of the decision. Other than clarification of matters addressed in the comments and reply comments, there were no material changes to the ALJs proposed decision.

Findings of Fact

1. This investigation was opened to determine if Part 32 should be adopted for telephone utilities subject to the Commission's jurisdiction.

2. The FCC's USOA has previously been adopted by this Commission with modifications because of our desire to simplify and coordinate the accounting and reporting requirements imposed on telephone utilities operating under the jurisdiction of both this Commission and the FCC.

3. The FCC issued Part 33 because it believes that the present USOA is archaic and incapable of providing for changes in a complex, competitive, technological, and economic environment.

4. Part 32 is to be effective January 1, 1988 for telephone utilities under the FCC jurisdiction.

5. FASB 87 is not addressed in this opinion but will be the subject of an opinion in January, 1988.

6. Full adoption of Part 32 and Part 36 will result in additional revenue requirements for the telephone utilities in the short-term.

7. Pacific Bell estimates an additional revenue requirement of $82 million in 1988 (assuming adoption of tax normalization and application of GAAP to embedded leasedhold improvements), GenTel $66 million, AT&T and Citizens $2 million, and ConTel $1 million.

8. Nominal impacts are estimated for Roseville and the smaller independent telephone utilities.

9. DRA has not examined the reasonableness of the utilities' estimates.

10. Present intrastate operations of telephone utilities, except AT&T, are approximately 80%. AT&T's is approximately 60%.

11. No projections of intrastate operations under Part 36 were provided because of ongoing modifications by the FCC.

12. PU Code § 793 requires the system of accounts and the forms of accounts, records, and memoranda prescribed by the Commission for corporations subject to the regulatory authority of the United States to not be inconsistent with the system and forms established for such corporations by or under the authority of the United States.

13. Parties to this investigation agree that Part 32 should be adopted.

14. DRA requests that the major utilities use one of DRA's four approaches identified in Chapter 7 of DRA's Exhibit 2 to restate 1987 data into Part 32 data.

15. DRA requests that the Commission's timetable established for the Rate Case Plan be extended one month to provide DRA additional time to coordinate with the utilities to understand Part 32 accounting requirements.

16. A majority of the respondent utilities recommend that the cost to implement Part 32 should be allocated between interstate and intrastate ratepayers.

17. Implementation costs are virtually all 1987 expenses and are recoverable through the separations process.

18. Part 32 requires certain indirect construction costs currently capitalized to be expensed.

19. The capital to expense shift will increase utilities' revenue requirements in the short-term. In the long-term this accounting change will result in revenue requirement savings.

20. All parties to this investigation concur that the capital to expense shift required by Part 32 be adopted for accounting and ratemaking purposes.

21. Part 32 adopts GAAP for accounting purposes to the extent regulatory considerations permit.

22. Part 32 adopts future GAAP changes automatically, unless the FCC notifies the telephone utilities to the contrary.

23. In those instances where GAAP permits more than one accounting method, the FCC will select the appropriate accounting method for use by the telephone utilities.

24. The adoption of GAAP changes will impact the utilities' revenue requirement similar to the adoption of the capital to expense shifts.

25. DRA recommends adoption of all GAAP changes with no revenue impact and adoption or modification of most of the remaining FCC adopted GAAP items having major revenue impacts.

26. DRA recommends GAAP be adopted for accounting purposes, however, DRA is silent on the ratemaking treatment.

27. The Commission's IDC formula is based on sound principles and has withstood litigation in several rate proceedings.

28. DRA does not object to the FCC selecting the appropriate accounting treatment in those instances where GAAP permits more than one accounting method.

29. All parties concur with Part 32's requirement that all leasehold improvements are to be capitalized separately and amortized over the term of the lease. Part 32 is silent on the treatment of embedded leasehold improvements.

30. GAAP requires compensated absences to be recorded as an expense in the year the liability is incurred.

31. GAAP requires the expected workers' compensation liability to be calculated and accrued as an expense in the current year.

32. GAAP requires incentive awards to be recorded on an accrual basis.

33. Contrary to the Commission's generic policy of requiring gains and losses from the early extinguishment of debt to be amortized over the life of the replacement debt, GAAP requires the gains and losses to be recognized as income or expense in the year of occurrence.

34. Part 32 does not substantially depart from the current accounting procedure for computer software development costs.

35. Computer software development costs intended for future revenue-generating services are currently reviewed on a case-by-case basis in general rate proceedings.

36. New software under development for future revenue-generating services is not addressed in Part 32.

37. Adoption of Part 32 requires the depreciation category of certain asset groups to change. This change results in the remaining life and depreciation accrual of the affected categories changing. The revenue requirement is nominal.

38. The utilities recommend tax normalization because it conforms with GAAP, results in a lower revenue requirement, and eliminates excessive record keeping.

39. DRA recommends the continuation of flow-through because it is consistent with current Commission policy, the Federal tax law is volatile, and normalization would only benefit the ratepayer in the short-term.

40. The issue of normalization versus flow-though was addressed as a generic policy in D.84-05-036.

41. The automatic adoption of future GAAP pronouncements is not in the best interest of the ratepayers.

42. A change in accounting for post retirement benefits from a cash basis of accounting to a accrual basis on the belief that the FASB is going to issue an exposure draft requiring the accrual method of accounting to be used is speculative.

43. Pacific Bell and DRA have developed a procedure to provide the Commission with necessary information to oversee and analyze affiliated company transactions.

44. AT&T would be burdened by the Pacific Bell and DRA procedure, if required to incorporate it into its nationwide accounting system.

45. The current separations manual is obsolete because it is structured by accounts identified in the current USOA.

46. Part 36 is structured by accounts identified in Part 32 and incorporates four rule changes.

47. All parties to the investigation recommend that Part 36 be adopted.

48. DRA has not analyzed the reasonableness of the utilities Part 36 revenue requirements.

49. One of the Part 36 rule changes require a DEM measurement replace the SLU measurement to determine shifts from access to exchange services for Category 6.

50. NTS costs associated with Category 6 will no longer be distinguished from traffic sensitive costs making it impossible to continue to apply a SPF to SLU factor to Category 6.

51. SPF to SLU is to continue to apply to the majority of NTS costs.

52. Prt 64 and Part 69 are not identified as issues in this investigation.

53. The utilization of a deferred account to record the additional revenue requirement from the capital to expense change until the cross-over point is reached, and the revenue requirement becomes negative would require the utilities to estimate and maintain subsidiary records showing the development of approximately twenty individual items. The utilities would also be required to estimate yearly rates of growth or decline, associated depreciation rates, construction expenditures, wage escalation factors, rate of return, and net-to-gross multipliers.

54. Use of a deferred account for revenue requirement impacts of capital to expense shifts would be costly.

55. Use of a balancing account on a temporary basis for revenue requirement impacts of capital to expense shifts will avoid an increase in the utilities' record keeping burden and expense, will provide a vehicle to isolate USOA impacts for further examination by DRA and enable the utilities to combine revenue requirement impacts of other proceedings before the Commission in rates at one time.

56. This investigation specifically states that while this opinion may have an impact on future ratemaking, in and of itself, it will not change existing rates.

57. There is no Commission intent to "guarantee" telephone utilities recovery of all costs associated with the adoption of Part 32.

58. Utilities are entitled an opportunity to recover the additional revenue requirement impact from Part 32.

59. GenTel requests that it be allowed to recover its revenue requirement impacts through its pending rate proceeding.

<u>Conclusions of Law</u>

1. FASB 87 should be addressed in a subsequent opinion in January 1988, because of the substantial amount of testimony received and the substantial amount of discussion in the interested parties' briefs filed October 30, 1987.

2. The telephone utilities' percentage of intrastate operations should not change with the adoption of Part 36.

3. PU § 793 and § 794 do not preclude the Commission from prescribing forms of accounts, records, and memoranda covering information in addition to that required by or under the authority of the United States.

4. The issue of whether PU Code § 793 requires the Commission to adopt Part 32 is moot since all parties to the investigation recommend that Part 32 be adopted.

5. A Commission order requiring major telephone utilities to provide DRA with 1987 data based on Part 32 should not be necessary because the major utilities have agreed to provide the data.

6. The Rate Case Plan timetable should not be extended an additional month because of the adoption of Part 32 because the entire schedule is under investigation in another proceeding.

7. Part 32 should be adopted to the extent provided by this opinion.

8. Part 32 implementation cost should be recoverable in the same manner as other operating expenses through the general ratemaking process and settlement pools.

9. Part 32 capital to expense shifts should be adopted for accounting and ratemaking purposes, to the extent that they do not conflict with Commission ratemaking policies discussed in this opinion.

10. The implementation of a deferred account to record the revenue requirements associated with Part 32 capital to expense shifts should not be adopted.

11. While this investigation was not opened to change existing utility rates, the utilities which have substantial revenue requirement impacts (Pacific Bell, GelTel, Citizens, and ConTel) from the adoption of Part 32 should be allowed an opportunity to recover their additional revenue requirement through the use of a balancing account for a period not to exceed one year.

12. The impact of GenTel's balancing account should not be addressed in the rate design phase of GenTel's pending rate proceeding until it has been audited by DRA.

13. By March 31, 1988, those utilities implementing a balancing account should file a summary of their balancing account as of February 29, 1988 with the Commission's Docket Office. DRA and any other interested party should file a report on the reasonableness of the balancing accounts and serve a copy on all parties to this investigation on or before May 2, 1988.

14. Part 32 impacts on AT&T, Roseville, and the smaller telephone utilities should be addressed in their next general rate proceeding or GO 96 filing.

15. GAAP as modified by this opinion should be adopted. Any revenue requirement impacts should be accounted for in a manner consistent with the treatment of capital to expense changes identified in this opinion.

16. The telephone utilities should continue to maintain appropriate accounting and ratemaking records to conform with the Commission's IDC formula.

17. Where GAAP permits more than one accounting method the utilities should use the method selected by the FCC. However, should any party object to the method selected by the FCC, that party should bring the issue before the Commission in a formal proceeding.

18. Leasehold improvements should be capitalized separately and amortized over the term of the lease. Embedded leasehold improvements should continue to be amortized over the life of the buildings account.

19. GAAP accounting for compensated absences and workers' compensation should be adopted with the embedded amounts to be amortized over a ten-year period.

20. GAAP accounting for incentive awards should be adopted. Any awards accruing for employees terminating service during the year and not receiving the award should be reversed. Embedded amounts should be amortized over a ten-year period.

21. Gains and losses from the early extinguishment of debt should be amortized over the life of the replacement debt.

22. The Commission's advice letter procedure should be utilized to address subsequent Part 32 changes.

23. The accrual basis of accounting for post retirement benefits should not be adopted at this time.

24. Computer software development costs for future revenue-generating services should continue to be addressed on a case-by-case basis.

25. Part 32 asset groups for depreciation should be adopted. Any changes in depreciation because of the reclassification of certain asset groups should be addressed during the utilities represcription of depreciation rates. The utilities should submit as part of their represcription filing the impact of rate changes caused by depreciation changes adopted in this order.

26. Telephone utilities should not abandon any accounting and ratemaking requirements instituted by this Commission in past proceedings unless changes were specifically discussed in this decision.

27. The utilities should use the procedures developed by Pacific Bell and DRA to account for and to track affiliated company transactions. AT&T should be permitted to provide information on affiliated company transactions on a side record basis and should not be required to use the procedures developed by Pacific Bell and DRA.

28. Part 36 should be adopted. Any revenue requirement impact should be treated similarly to the capital to expense revenue requirement impacts. Supporting workpapers should be maintained for review by the Commission's DRA.

29. The DEM measurement should be used in place of the current SLU measurement to determine shifts from access to exchange services for Category 6, only.

30. Part 32 comprehensive normalization for income taxes should not be adopted. Flow-though of income taxes should continue.

31. Part 64 and Part 69 should not be addressed in this investigation.

32. Part 32 and Part 36 as modified by this opinion should be effective January 1, 1988 to conform with the FCC's implementation date of Part 32 and Part 36.

INTERIM ORDER

IT IS ORDERED that:

1. The Federal Communications Commission's (FCC) Part 32, Uniform System of Accounts for Telephone Corporations, is adopted to the extent provided in the above opinion and shall be applicable to all telephone utilities under the Commission's jurisdiction. Generally Accepted Accounting Principles (GAAP) currently in effect are adopted except as otherwise provided in the above opinion and shall be applicable to all telephone utilities under the Commission's jurisdiction.

2. The FCC's Part 36, Separations Manual, is adopted and shall be applicable to all telephone utilities under the Commission's jurisdiction.

3. Costs incurred to implement Part 32 shall be recoverable in the general ratemaking process and settlement process, similar to the recovery of other operating expenses.

4. Pacific Bell, General Telephone Company of California, Citizens Utilities Company of California, and Continental Telephone Company of California are authorized to initiate a balancing account on their books of account to record revenue requirement impacts from the adoption of Part 32 and Part 36. The balancing account shall bear interest at the 90-day commercial paper rate.

5. Utilities implementing a balancing account shall file as part of this investigation a summary of their balancing account as of February 29, 1988 with the Commission's Docket Office and shall serve copies on all interested parties on or before March 31, 1988. Concurrently, detailed supporting workpapers shall be provided to the Division of Ratepayer Advocates, and shall be provided upon request to other interested parties.

6. The Division of Ratepayer Advocates and any other interested party shall file as part of this investigation a report of the reasonableness of the utilities' balancing account and serve copies on all parties to this investigation on or before May 2, 1988.

7. The balancing account shall terminate no later than January 1, 1989 in connection with our investigation into regulatory flexibility instituted November 25, 1987 (I.87-11-033).

8. Revenue requirement impacts from adoption of Part 32 and Part 36 on all other telephone utilities shall be addressed in their next general rate proceeding or General Order 96 filing.

9. The telephone utilities shall continue to maintain appropriate accounting and ratemaking records to conform with the Commission's Interest During Construction formula for construction projects.

10. The telephone utilities shall continue to conform with the Commission's policy of amortizing gains and losses from the early extinguishment of debt over the life of the replacement debt.

11. The Commission's advice letter procedure shall be used to address subsequent Part 32 changes.

12. Regarding Part 32 changes, major telephone utilities (Pacific Bell, General Telephone Company of California, AT&T Communications of California, Inc., Continental Telephone Company of California, and Citizens Utilities Company of California) shall provide to the Division of Ratepayer Advocates and Commission Advisory and Compliance Division Directors:

a. Concurrent copies of any Part 32 petition and/or revenue requirement filed with the FCC.

b. For GAAP changes, revenue impact studies within 90 days after the FASB releases its final pronouncement.

c. For Part 32 changes initiated by the FCC, FCC required studies concurrent with their FCC filing.

13. Computer software development costs for future revenue-generating services shall continue to be addressed on a case-by-case basis.

14. Telephone utilities engaged in affiliated company transactions shall conform to the affiliated company transaction procedures developed by Pacific Bell and DRA and record affiliate company transactions of a nature previously includable in Account 674, General Services and Licenses as follows:

a. For each Part 32 account to which costs are assigned, a separate and unique subaccount code (e.g., function code, reporting code, or expenditure code) shall be set up to record the affiliate costs chargeable to that account.

b. Affiliate company subaccount codes shall be used exclusively to record affiliate company costs.

c. The cumulative total recorded in affiliate company subaccounts' codes for a period shall reconcile with the affiliate company billing for that period.

d. Subsidiary records to support the monthly affiliate billings shall be set up and maintained with such records providing an audit trial to the Part 32 account assigned affiliate costs and a year-to-date accumulation of the total costs billed by the affiliate.

e. Supplemental memorandum records shall be maintained for surveillance purposes to track Commission adopted affiliate company adjustments.

f. For rate proceedings, the utilities are to submit their test year affiliate company estimated costs separately.

g. AT&T shall maintain its data on affiliate company costs on a side record basis and shall not be required to set up a separate and unique subaccount code to record these costs.

15. The Dial Equipment Minutes measurement shall be used in place of the current Subscriber Line Usage measurement to determine shifts from access to exchange services for Central Office Category 6, only.

16. The Commission Advisory and Compliance Division shall review the FCC's Part 64 and Part 69, when available, and report to the Commission whether an investigation should be opened.

17. This proceeding remains open for further decision on FASB 87.

This order is effective today.

Dated DEC 22 1987, at San Francisco, California.

STANLEY W. HULETT
President
DONALD VIAL
FREDERICK R. DUDA
G. MITCHELL WILK
JOHN B. OHANIAN
Commissioners

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Victor Weisser, Executive Director

APPENDIX A

CHAPTER 11

PRIOR COMMISSION RATEMAKING POLICIES

1. In PSD's March 17, 1987 data request, we asked that all utility respondents to OII 87-02-023 identify "all prior Commission Decesions by citation, section and ordering paragraph which required special accounting methods and procedures which may be affected by this proceeding." The reason for this request was to assure ourselves that prior ratemaking adjustments which were based in Part 31 accounting would not be eradicated by the adoption of Part 32.

2. Pacific Bell responded on June 15, 1987, nearly three months after PSD made the request. Pacific Bell identified only one Commission decision involving special treatment which would be affected by this proceeding, Decision 86-01-026, Interim Order, Ordering Paragraph 6 regarding expense bookings to Account 674. This decision is discussed in Section C of this chapter.

3. General Telephone's (General's) response, received March 27, 1987 identified two decisions, 85-03-042 (addresses attrition methodology) and 84-07-108 (discussed later in this chapter). However, General qualified their response by stating:

> The orders reviewed represent those from recent rate case and attrition filings which were readily accessible.

4. Continental Telephone (Continental) responded on April 30, 1987, stating:

> Extensive legal research would be necessary in order to respond to this question. Since the Commission applies similar policies to all telephone companies, the responses by the different telephone companies to this question would be very similar. Continental, therefore, suggests that the Staff review Pacific Bell's response to this question. If

the Staff still believes that Pacific's response is not complete with respect to Continental, we will then undertake the cost of this legal research.

As can be seen from Pacific Bell's and General's responses discussed above, responses have not been similar.

5. Citizens Utilities Company (Citizens) stated that they were "not aware" of any prior decisions that require them to use any special accounting methods and procedures which may affect this proceeding. Roseville Telephone (Roseville) stated unequivocally:

> There are no Commission decisions which apply to Roseville pertaining to special accounting methods and procedures.

AT&T also qualified their response by stating:

> As we interpret data request #1, there are no special accounting methods and procedures for AT&T-C ordered by the California Public Utilities Commission which will be affected by this proceeding.

6. PSD was unable in the time allowed to do adequate research of our own on this issue and we have not examined the completeness of the companies' responses. We remain concerned that the adoption of Part 32 may have the unforeseen side effect of eradicating prior Commission decisions and policies which have been adopted over the years. In order to avoid this, we recommend that if such issues arise, they be addressed in each utility's separate rate proceeding. Furthermore, the adoption of Part 32 should not be considered a valid reason for any telephone company to abandon accounting and ratemaking requirements instituted by this Commission in past proceedings.

7. What follows is a discussion of some of the accounting and ratemaking issues which we have researched to date.

APPENDIX A

A - PACIFIC BELL

8. After receiving Pacific Bell's response on June 15, 1987 indicating that this Commission had required only one special accounting procedure which could be affected by this proceeding, Staff sent another data request on June 19, 1987 asking for differences between Part 32 accounting and current CPUC policy which had not previously identified as GAAP or capital to expense shift differences.

9. Pacific Bell responded on July 13, 1987 with the following differences between current CPUC policies and procedures and the FCC's prescribed Part 32 accounting:

1. Issue:	Intrastate Depreciation
Current CPUC Treatment:	The CPUC prescribes depreciation methodologies different form the FCC requiring adjustment of the USOA books.
FCC Treatment:	Depreciation is recorded on the books as prescribed by the FCC.
2. Issue:	Interest During Construction (IDC)
Current CPUC Treatment:	CPUC ratemaking provides for the accrual of IDC on short-term construction projects (those completed within one year).
FCC Treatment:	The FCC specifies that sort-term construction projects be included in rate base. Therefore, an allowance for funds used during construction is not accrued.

3.Issue:	Expensing Station Connection Costs
Current CPUC Treatment:	The CPUC ordered station connection costs previously capitalized to be amortized over 10 years, beginning 11/28/81. The FCC ordered a similar 10 year amortization, but beginning 1/1/81. Differences between the start of the amortization periods are recorded as an adjustment to the Part 31 books.
FCC Treatment:	Part 32 will continue to reflect the FCC amortization order.
4.Issue:	CPUC Disallowance of Western Electric Excess Profits
Current CPUC Treatment:	CPUC disallows such profits via an adjustment to Part 31 plant and depreciation.
FCC Treatment:	This disallowance is not reflected on the FCC books.
5.Issue:	Deferral Of The Income Effect On The Sale of Land
Current CPUC Treatment:	The CPUC requires the net gain on the sale of land be deferred until a test year results of operation or an attrition filing.
FCC Treatment:	Part 32 requires the income effect of these sales to recognized at the time of the transaction.
6.Issue:	Deferral of Bellcore 800 Services System Costs
Current CPUC Treatment:	The CPUC Decision 86-01-026 requires that Pacific Bell defer its share of the Bellcore expense associated with the developing a new 800 number service program until the new system is operational and tariffs are in place.
FCC Treatment:	Costs are expensed per SFAS No. 2.

7. Issue: Equal Access

Current CPUC Treatment: The CPUC prescribes that Equal Access costs are to be recovered through the use of a balancing account. The FCC has specified that such costs be fully amortized by 1992. Differences in these recovery methods are recorded as adjustments to the Part 31 books.

FCC Treatment: Part 32 does not change the FCC's prescribed recovery method.

8. Issue: Investment Credit

Current CPUC Treatment: Adjustments are made to Part 31 books to reflect the restoral of investment credits lost as a result of the IRS closing agreement in the Remand Case. For ratemaking purposes, the CPUC treats these credits as if they were on a fully eligible basis.

FCC Treatment: The USOA books recognize the loss of eligibility of these credits at the time of the IRS closing agreement.

10. Complete adoption of Part 32 would require changes to the CPUC policies listed above, in addition to affiliate transactions as identified in Pacific Bell's June 15, 1987 response. PSD believes that the current Commission policies should not be changed.

B - GENERAL TELEPHONE

Decisions

11. In response to PSD's March 17, 1987 data request, General Telephone identified CPUC Decision 84-07-108 (July 18, 1984) as containing accounting or ratemaking adjustments which may be impacted by the adoption of Part 32 accounting. In that decision the CPUC restated its October 22, 1980 opinion in Decision 92366

that General Telephone should allocate a portion of its general office salaries in and above the salary grade level of manager to construction for both accounting and ratemaking purposes. The Commission also adopted staff's expense estimate of Expenses Charged to Construction - Credit (Account 677) in Decision 82-04-028 (April 6, 1982). Staff's adjustment again included an allocation of salaries of general office personnel in public affairs, accounting, legal, revenue requirements, and treasury departments to construction. In adopting staff's recommendation the Commission stated:

> In D. 92366 we stated that "given the magnitude of General's current construction program, it is difficult to conceive of any of the managerial personnel not being involved in one way or another." Such an observation appears as valid today as it did at the time of the issuance of D. 92366 and we will therefore adopt the staff's expense estimate. . .

12. Further discussion of this issue is contained in Chapter 2, Section IV.

Policies

13. In addition to the CPUC ratemaking adjustments discussed above, General also identified the $25,000 to $100,000 shift for Telephone Plant Under Construction as a policy issue.

14. The CPUC's current treatment is that all charges to work orders whose budget is greater than $25,000 and greater than 60 days are placed in Account 100.2 - Telephone Plant Under Construction. Under Part 32, all charges to work orders whose budget is greater than $100,000 and one year are placed in Account 2004 - Telephone Plant Under Construction - Long Term. All charges to work orders whose budget is greater than $100,000 and 60 days but

less than one year are placed in Account 2003 - Telephone Plant Under Construction - Short Term.

15. According to General Telephone's response to PSD data request USOA-023, based on May 1987 data, $33.3 million will transfer from Telephone Plant Under Construction to Telephone Plant in Service. General estimated that, on an annualized basis, this will result in a reduction of FCC Interest During Construction (IDC) of $193,000 and CPUC IDC of $3.5 million based on the current IDC rate being used by General.

16. PSD has not reviewed this issue in detail, so we have no comments or recommendations at this time.

C - AFFILIATE COMPANY TRANSACTIONS

Background

17. Telephone utilities traditionally record their affiliate company transactions under Part 31 in Account 674 - General Services & Licenses (Account 674). More specifically, General Telephone and Continental Telephone Companies currently use Account 674 to record costs billed from their affiliated service corporations, GTE Service Corporation and Contel Service Corporation, respectively. Pacific Bell uses this account to record their affiliate company billings from Bell Communication Research and the Pacific Telesis Companies in conformance with accounting procedures adopted in CPUC Decision 86-01-026, Interim Order, Ordering Paragraph 6, dated January 10, 1986.

18. Under Part 32, the FCC did not provide for an Account 674 type account to record affiliate company transactions. For its jurisdictional purposes, the FCC required telephone utilities to

account for their affiliate costs by disaggregating them to appropriate Part 32 accounts based on the nature of the affiliate transaction. For example, the cost of legal services provided by an affiliate would be recorded to Part 32, Account 6725 - Legal, while affiliate incurred costs to develop non-technical training programs would be recorded to Part 32, Account 6723 - Human Resources.

19. During the Part 32 comment phase, NARUC and many state commissions, including the CPUC, submitted arguments to the FCC to retain a single expense account similar to Account 674 under Part 32 for purposes of recording affiliate company transactions. In the CPUC Comments on Part 32, dated May 2, 1985, the CPUC echoed NARUC's position and advocated the importance of establishing a single expense account to maintain a close surveillance of affiliate company transactions. The CPUC expressed the concern that the disaggregation of affiliate company billings could create an additional burden for regulators. By spreading affiliate company billings to over a dozen accounts, the audit trail for affiliate transactions becomes obscure, increasing the possibility that traditionally questionable affiliate company expenditures could be concealed or incorrectly treated in a rate case proceeding.

20. The CPUC has maintained a close surveillance of affiliate transactions recognizing that potential cross-subsidization abuses exist when regulated utilities deal with related, unregulated companies in a less than arm's length environment. The CPUC voiced the need to continue the aggregation of affiliate

costs in a single account to continue its effective monitoring of affiliate transactions. In its analysis of Account 674 over the past ten years, the CPUC staff has been able to identify numerous affiliate issues resulting in substantial disallowances.

21. In setting forth its order to estalish Part 32's Rules and Regulations, the FCC, however, elected not to consider the single expense account argument for affiliate company transactions, because it ran contrary to the FCC's goal of recording expenses based upon their functional nature. The FCC did not present an alternative solution to alleviate the concerns expressed by California and other state commissions regarding affiliate transactions.

PSD Analysis and Position

22. Given the FCC position to account for affiliate company transactions on a disaggregated, functional accounting basis, PSD focused its analysis in this OII on establishing a means to effectively regulate affiliate company transactions under Part 32. From responses to PSD data requests and from discussions with utility personnel, PSD believes that it can work with the prescribed Part 32 affiliate company accounting requirements provided the following safeguards are undertaken by utilities:

- Within each Part 32 account assigned affiliate costs, a separate and unique subaccount code (e.g., function code, reporting code, expenditure code, etc.) is to be set up to record the affiliate costs chargeable to that account.

- Affiliate company subaccount codes are to be used exclusively to record affiliated company costs, and affiliate company costs are not to be recorded under non-affiliate company subaccount codes.

- The cumulative total recorded in affiliate company subaccounts codes for a period must reconcile with the affiliate company billing for that period.

- Subsidiary records to support the monthly affiliate billings are to be set up and maintained with such records providing an audit trail to the Part 32 account assigned affiliate costs and a year-to-date accumulation of the total costs billed by affiliate.

- Supplemental memorandum records are to be maintained for surveillance purposes to track the CPUC adopted affiliate company adjustments.

- For rate proceedings, the utilities shall submit their workpapers to the CPUC showing their test year affiliate company estimated costs separately. In other words, affiliate company test year estimated costs are to be excluded from Part 32 account test year estimates. The utilities must also identify in their workpapers the affiliate company costs excluded from each Part 32 account affected.

23. The above safeguards have been set up to provide an adequate audit trail for the affiliate company costs and to prevent "double counting" or mistreating affiliate company transactions in rate proceedings. Although we prefer the single account approach, PSD believes that this compromise approach involving the above safeguards would not adversely hamper our ability to analyze these transactions. Moreover, it would allow utilities to present affiliate company costs on a consistent basis for federal and state reporting purposes.

24. From our discussions with various utilities involved with affiliate company transactions, the above compromise approach was perceived to be workable. Of particular note, Pacific Bell has agreed in writing to the safeguards proposed and has provided a sample of records to document their ability to comply. With

respect to General Telephone, the utility has stated that they would not have any problems complying with the proposed safeguards.

(END OF APPENDIX A)

ALJ/MJG/jc

Decision ___________

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into a) whether the FCC Part 32, Uniform System of Accounts for Telephone Companies (USOA) should be adopted for telephone companies subject to the Commission's jurisdiction, b) the effect on intrastate rates if all or any portion of the USOA is adopted and c) the ratemaking treatment of the implementation cost associated with the USOA.	I.87-02-023 (Filed February 11, 1987)

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Randolph Deutsch, Attorney at Law, for AT&T Communications of California, Inc.; Patricia L. C. Mahoney, Attorney at Law, for Pacific Bell; Richard E. Potter and Kenneth K. Okel, Attorneys at Law, for General Telephone Company of California; Pelavin, Norberg, Harlick & Beck, by Alvin Pelavin, Jeffrey F. Beck, and Alan M. Weiss, Attorneys at Law, for Calaveras Telephone Company, California-Oregon Telephone Co., Capay Valley Telephone System, Inc., Ducor Telephone Company, Evans Telephone Company, Foresthill Telephone Co., Happy Valley Telephone Company, Hornitos Telephone Company, Kerman Telephone Co., Pinnacles Telephone Company, The Ponderosa Telephone Co., Sierra Telephone Company, Inc., The Siskiyou Telephone Company, and The Volcano Telephone Company; Orrick, Herrington & Sutcliffe, by Robert J. Gloistein, Attorney at Law, for Continental Telephone Company of California; John L. Clark, for CP National and Tuolumne Telephone; Arthur Smithson, for Citizens Utilities Company of California; and Mark P. Shull, for Roseville Telephone Company; respondents.

C. Hayden Ames, Attorney at Law, for Chickering & Gregory; John J. Gibbons, for himself; and Octavio Lee, for the State of California, Board of Equalization; interested parties.

Catherine A. Johnson, Attorney at Law, and Thomas Lew and Kevin P. Coughlan, for the Division of Ratepayer Advocates.

INTERIM OPINION

I. Background

On February 11, 1987, the Commission issued an order instituting investigation (investigation) to determine the Federal Communications Commission's (FCC) Part 32, Uniform System of Accounts for Telephone Companies (USOA) should be adopted for telephone companies subject to the Commission's jurisdiction.

Currently, telephone corporations under our jurisdiction are required to follow the FCC's USOA implemented in 1935 and as amended by the FCC and adopted by this Commission with certain exceptions. One such exception occurred in 1965 (Decision (D.) 68534, 64 Cal. P.U.C. 27 (1965)) when we chose not to adopt the FCC's deferred accounting for investment tax credits. However, in general, the FCC's USOA has been adopted because of our desire to simplify and coordinate the accounting and reporting requirements imposed on those telephone companies operating under the jurisdiction of both this Commission and the FCC.

The FCC issued Part 32 because it believes that the present USOA is archaic and incapable of providing for changes in a complex, competitive, technological, and economic environment.

Part 32, to be effective January 1, 1988 for telephone companies under the FCC jurisdiction, reflects a financial based accounting system to facilitate the monitoring of revenues, expenses, and investments by product, service, purpose and type; facilitate management reporting data for cost of service and the separations and settlement process; and to accommodate generally accepted accounting principles (GAAP) to permit a closer alignment with business which is not regulated.

Our investigation identified the following six issues to be addressed in the proceeding:

a. Percentage of California telephone utility operations intrastate, subject to this Commission, and percentage interstate, subject to the FCC.

b. Whether Public Utilities (PU) Code § 793 requires the Commission to adopt the FCC's Part 32.

c. Identification and quantification of implementation costs and who should bear the burden of those costs.

d. If adopted either in whole or in part should any modifications be required for intrastate purposes.

e. Effects on financial reporting, separations, and revenue requirements from adoption of Part 32 either in whole or in part.

f. Identification and analysis of other provisions of Part 32 which may affect California ratemaking policies.

A prehearing conference was held before Administrative Law Judge (ALJ) Galvin on March 17, 1987. Respondent telephone utilities agreed to file their response to issues a, b, and c by April 3, 1987. At the request of respondents and interested parties, informal workshops were scheduled to determine areas of agreement among respondents and interested parties, and to reduce the amount of time needed for formal hearings. Workshops, set for May 11, 12, and 19 through 22, 1987, were moderated by the Commission's Advisory and Compliance Division (CACD), formerly the Evaluation and Compliance Division. However, parties to the investigation were unable to reach any consensus.

Evidentiary hearings were held during the months of August and October of 1987. Testimony was received from approximately two dozen witnesses representing respondents and interested parties. Thirty-six exhibits were received into evidence.

Concurrent briefs on all issues except for the accounting and reporting of pension expense, tax normalization, cost allocation manual, and a legal argument on the adoption of the FCC's new separations manual (Part 36) were filed on September 10, 1987. Concurrent briefs on the remaining issues were filed on October 30, 1987.

All issues except for the accounting and reporting of pension expense are considered in this opinion. This is because of the substantial amount of testimony received on Financial Accounting Standards Board (FASB) 87 and the substantial amount of discussion in interested parties October 30, 1987 briefs on this matter. A subsequent opinion, expected to be issued in January 1988, will address FASB 87.

Full adoption of Part 32 and Part 36 is estimated to result in additional revenue requirements for the telephone utilities in the short-term. This additional revenue requirement is to be reduced gradually and after about seven years should result in a revenue requirement savings because of the shift of costs from utility plant to operating expense.

Although nominal impacts are estimated for the smaller independent telephone companies there are some significant impacts on the larger telephone utilities for 1988. Pacific Bell estimates an additional revenue requirement of $82 million in 1988, General Telephone Company of California (GenTel) $66 million on a total company basis and approximately $46 million intrastate (exclusive of settlement effects), AT&T Communications of California (AT&T) and Citizens Utilities Company of California (Citizens) $2 million, and Continental Telephone Company of California (ConTel) $1 million.

The Commission's Division of Ratepayer Advocates (DRA), formerly the Public Staff Division, acknowledges that additional revenue requirements will occur with the adoption of Part 32's capital to expense shift and GAAP. However, DRA's witnesses have not examined the reasonableness of the utilities' estimates. DRA represents that it has been unable to determine the reasonableness of the utilities' estimates because of continuous revisions of estimates by utilities.

II. Intrastate Operations

The first issue in the investigation requires a determination of the percentage of California telephone utility operations that is intrastate, subject to our regulation. Respondent utilities' filings show that their intrastate operations, except for AT&T, are approximately 80% and their interstate operations are approximately 20%, based on the current separations procedures. AT&T's intrastate operations are approximately 60% and interstate operations are approximately 40%. No projection of intrastate operations under the new separations manual were provided because of ongoing modifications by the FCC. However, the intrastate factor is not expected to be changed materially by the new separations manual.

III. Public Utilities Code § 793

The second issue to be addressed in this investigation is to determine if PU Code § 793 requires the Commission to adopt the FCC's Part 32. This section of the code states that the system of accounts and the forms of accounts, records, and memoranda prescribed by the Commission for corporations subject to the regulatory authority of the United States, shall not be inconsistent with the system and forms established for such corporations by or under the authority of the United States. Nothing in this section or § 794 affects the power of the Commission to prescribe forms of accounts, records, and memoranda covering information in addition to that required at the federal level.

Parties to this investigation unanimously agree that Part 32 should be adopted; therefore, this issue should be moot. However, the DRA's recommendation that the utilities be required to maintain supplemental accounting records, such as memoranda or side records for interest during construction and gains or losses on the early extinguishment of debt, is of concern to the respondent utilities.

The small independent telephone utilities are concerned that the supplemental accounting record proposal may require utilities to maintain two separate sets of accounting records. Even though Pacific Bell acknowledges that it can continue, as is does presently, to provide such additional records to the extent that the required information is available within its primary set of accounting records, Pacific Bell is concerned that DRA is seeking information which uses the present USOA structure which would require a separate set of accounting records.

A majority of this confusion stems from DRA's recommendation that respondent utilities implement a data continuity mechanism for converting new data into the old USOA accounting format to provide periodic reports. However, DRA's witness, Mirza, clarified DRA's proposal to require major utilities to have in place "a mechanism and a one-year date, most likely 1988," to restate 1987 data into Part 32 data. DRA proposes that the utilities use one of the four approaches identified in Chapter 7 of DRA's Exhibit 2.

The PU Code and General Orders already require utilities to provide specific financial data. In this instance, Mirza testified that the major utilities, except for AT&T, have agreed to provide data. They will use one of DRA's approaches but did not specify which one. Subsequently, AT&T's witness, Thiebaud, stated that with DRA's clarification of its request for data continuity, AT&T could satisfy DRA's request. Therefore, since major utilities have already agreed to provide the data requested by DRA, there is no further need for the Commission to require it formally.

DRA also requests that the Rate Case Plan established by the Commission for a notice of intent (NOI) to file a general rate case be revised to allow DRA additional time to coordinate with the utility to understand Part 32 accounting requirements adopted by this Commission and the data continuity process discussed above.

The Rate Case Plan timetable and procedure is currently undergoing a review by the Commission in R.87-11-012 to consider effects of legislative changes which took place subsequent to the establishment of the Plan, such as PU Code § 311. Accordingly, DRA's request for modification of the Rate Case Plan timetable should be considered in the overall review and not be addressed in this investigation.

IV. Implementation Cost

Respondent utilities filed a summary of their projected cost to implement Part 32 and recommended how such costs should be recovered.

Implementation cost varied among utilities. Pacific Bell projected a $16 million implementation cost, GenTel $2 million, and the smaller independent telephone utilities under $25,000. The majority of the implementation costs consists of redesigning computer systems and related programming and staff training.

A majority of the respondent utilities recommend that costs incurred to implement Part 32 be allocated between interstate and intrastate ratepayers, similar to other legitimate costs, according to the current separations procedures. Although Citizens recommends that it be authorized to recover its implementation cost through a balancing account mechanism, GenTel does not believe that such cost should be recovered because implementation costs are virtually all 1987 expenses and recoverable through the separations process.

DRA concurs with GenTel's conclusion because the majority of the implementation costs are non-incremental, involving costs of existing staff and resources which are already recovered through current rates. To the extent that incremental costs exist, the majority of these costs will be recovered through the existing settlement process without further action by the Commission.

We concur with DRA and GenTel. Implementation costs should be recoverable in the same manner as other operating expenses, that is, through the general rate making process and settlement pools.

V. Capital to Expense Shifts

Indirect construction costs, comprised of approximately twenty distinct components, are currently capitalized but are to be expensed under Part 32. Such indirect costs include general office overheads, labor related additives, property taxes, and loss of materials and supplies associated with construction projects.

Although this accounting change will increase the utilities' revenue requirements during the initial years of implementation, a cross over point, where revenue requirement is to go negative, is estimated by DRA to occur in the mid 1990's.

Approximately seven years after implementation, this accounting change will result in a revenue requirement savings because its adoption will reduce the utilities' recorded rate base. To illustrate, adoption of this accounting change effective January, 1988 will increase Pacific Bell's revenue requirement by approximately $118 million, GenTel's by approximately $57 million, AT&T and Citizens by approximately $2 million, and ConTel by approximately $1 million in 1988. In 1993, Pacific Bell's additional revenue requirement is to be reduced by $112 million to $6 million and GenTel's by $54 million to $3 million. Revenue requirement savings are to incur starting in 1994. The smaller telephone utilities will occur minimal or no impact from this accounting change.

Each party to this investigation, including DRA, concurs that the accounting change for indirect construction costs should be adopted for accounting and ratemaking purposes. However, they disagree over how the utilities should recover the resulting revenue requirement for ratemaking purposes.

We conclude that Part 32 capital to expense shifts to the extent they do not conflict with Commission's current ratemaking policies identified in Chapter 11 of DRA's Exhibit 2 will be adopted. The method of recovery of the costs associated with this shift is discussed in a subsequent section of this decision.

VI. Generally Accepted Accounting Principles

GAAP are a common set of accounting concepts, standards, procedures and conventions which are recognized by the accounting profession as a whole and upon which most nonregulated enterprises base their external financial statements and reports.

Part 32 adopts GAAP for accounting purposes to the extent regulatory considerations permit. Future GAAP changes are to be adopted automatically, unless the FCC notifies the telephone utilities to the contrary. In those instances where GAAP permits more than one accounting method, the FCC is to select the appropriate accounting method for use by the telephone utilities.

The adoption of GAAP changes, exclusive of tax normalization discussed in a subsequent section of this opinion, will initially result in the need for additional revenue requirements for Pacific Bell and GenTel. However, the need for additional revenue requirements will decrease over the years and in approximately the seventh year will result in a revenue requirement savings.

Due to GAAP alone, Pacific Bell's 1988 additional revenue requirement, excluding the effects of tax normalization, is estimated to be $44.2 million; GenTel's is estimated to be $9 million. In 1993 Pacific Bell's revenue requirement is to be reduced by $17.5 million to $26.7 million and GenTel's by $7.4

million to $1.2 million. There are to be nominal, if any, revenue requirements changes for AT&T and the smaller independent telephone companies.

DRA recommends adoption of all the changes which have no revenue impact and adoption or modified adoption of most of the remaining FCC adopted GAAP items which have major revenue impacts. The adoption was recommended for accounting purposes only. DRA is silent on the ratemaking treatment for the additional revenue requirement caused by GAAP. However, DRA does recommend that all future GAAP promulgations be considered for accounting and ratemaking purposes on a case-by-case basis. GAAP issues identified by DRA are:

a. Interest During Construction
b. Accounting Methods
c. Leasehold Improvements
d. Compensated Absences
e. Contingent Liabilities, Workers Compensation
f. Incentive Awards
g. Early Extinguishment of Debt
h. Computer Software Cost
i. Depreciation
j. Comprehensive Normalization
k. Future GAAP Changes

a. <u>Interest During Construction</u>

The FCC proposes no changes to its Interest During Construction (IDC) formula in Part 32. However, because the FCC allows short-term construction projects to be included in rate base, DRA opposes the adoption of the FCC formula in favor of the Commission's IDC formula. The Commission formula provides for the accrual of IDC on construction projects expected to be completed within one year.

GenTel recommends the FCC formula be adopted. It believes that DRA is advocating a short-sighted position because, although $9 million of GenTel's $66 million additional revenue requirement in 1988 is due to the FCC's IDC method, in the long-term (approximately seven years) GenTel will experience a revenue requirement savings. There is no impact on Pacific Bell because Pacific Bell does not seek a change in this Commission's IDC formula in this investigation.

The Commission's IDC formula is based on sound principles and has withstood litigation in several of Pacific Bell's and GenTel's rate proceedings. This investigation has produced no evidence to demonstrate that the FCC's formula is superior to the Commission's IDC formula. Therefore, the telephone utilities should continue to maintain appropriate records to conform to the Commission's IDC policy.

b. Accounting Methods

As previously discussed, where GAAP permits more than one accounting method the FCC proposes to select the appropriate method for use by the telephone utilities. Other than DRA's vague statement that there may be individual instances where DRA needs additional information to review the accounting method selected by the FCC, there were no objections.

Therefore, in those instances where GAAP permits more than one accounting method the telephone utilities should follow the accounting method selected by the FCC. If the telephone utilities, DRA, or any other party objects the method selected by the FCC that party should bring the issue before the Commission in a formal proceeding (such as a general rate proceeding).

c. Leasehold Improvements

Under GAAP all leasehold improvements are capitalized separately and amortized over the term of the lease, which is generally shorter than the life of a building. Pacific Bell estimates an additional $10.1 million revenue requirement for 1988 should this GAAP provision be adopted. Part 32 is silent on the treatment of embedded leasehold improvements capitalized as a part of the buildings account and currently amortized over the life of the building.

There is no opposition to using GAAP for leasehold improvements on a prospective basis. DRA proposes that embedded leasehold improvements currently in the buildings account be amortized over the life of the buildings account. However, DRA's witness testified that DRA would reconsider its position should the FCC, currently considering amortizing embedded leasehold improvements, promulgates a specific method of amortizing the embedded amounts.

We concur with DRA. Leasehold improvements should be capitalized separately and amortized over the term of the lease. Embedded leasehold improvements should continue to be amortized on a prospective basis over the life of the buildings account.

d. Compensated Absences

GAAP requires compensated absences to be recorded as an expense in the year the liability is incurred. The embedded liability is to be amortized over ten years to ease rate shock. This is a departure from the Commission's current policy of recording compensated absences as an expense in the year the cash is actually paid out. Pacific Bell estimates this change will result in a constant additional revenue requirement of $19.2 million.

DRA does not object to the Part 32 accrual treatment of compensated absences; however, it recommends that "if a situation arises in which a utility receives cash before the cash is actually expended, this situation should be accounted for in the calculation of working cash allowed in rate base."

Since there is no opposition to the treatment of compensated absences, the telephone utilities should conform to Part 32 in accounting for compensated absences. DRA's proposed working cash treatment for cash received by a utility prior to the cash being expended should be addressed on a case-by-case basis in general rate cases.

e. Contingent Liabilities, Workers' Compensation

GAAP requires the expected liability for workers' compensation to be calculated and accrued as an expense in the current year. Pacific Bell estimates that adoption of this proposal would increase its 1988 revenue requirement by $5.8 million. Since Pacific Bell is the only utility which is self-insured for workers' compensation, this proposal does not currently affect the other utilities.

DRA does not oppose this treatment; however, it believes that because GAAP tends to overstate the amount of liability, Pacific Bell and any other utility using the contingent liability approach should use a mid-range estimate to record its liability.

Again, there is no opposition to the principle of applying GAAP. Therefore, the accrual basis of accounting for workers' compensation should be adopted. However, because of the need to estimate the amount of liability for workers' compensation disputes regarding the reasonableness of the liability will occur. Rather than requiring mid-range estimates, the utilities should maintain necessary documentation to support their liability.

f. Incentive Awards

GAAP requires incentive awards to be recorded on an accrual basis. The FCC did not address this matter in Part 32. DRA represents that Pacific Bell already reports incentive awards on the accrual basis of accounting.

DRA recommends that if GAAP is adopted for incentive awards, the utilities should be required to account separately for the amounts which are accrued for employees who terminate during the year. The accruals for these employees should be reversed.

We concur. GAAP should be adopted for incentive awards and any awards accruing for employees terminating service during the year and not receiving the award should be reversed.

g. Early Extinguishment of Debt

GAAP requires that gains and losses from the early extinguishment of debt be recognized in the year of occurrence. However, the Commission's generic policy has been to amortize gains and losses over the life of the replacement debt.

Other than the utilities' recommendation that GAAP be adopted, no justification to change the Commission policy has been offered. The utilities should continue to amortize gains and losses from the early extinguishment of debt over the life of the replacement debt.

h. Computer Software Costs

The costs associated with initial operating systems' software purchased for general purpose computers and certain associated right-to-use fees are to be capitalized while applications software and recurring right-to-use fee are to be expensed.

The only dispute in the accounting for software costs is in the expensing of software systems being developed internally and applications systems for future revenue-generating services. DRA's witness, Amato, recommends that such software be capitalized under a deferred accounting approach for recovery of costs when the utility actually starts offering the service, similar to the accounting for Pacific Bell's 800 service software development cost required by D.86-01-026.

Amato recommends the deferral treatment because such costs:

a. Relate to future services and deferral would allow the timing of cost recognition to coincide with revenue recognition.

b. May be incurred to develop non-regulated, competitive service offerings. If expensed immediately, ratepayers would be burdened with paying the utility for services which may never benefit them.

c. May be incurred for a system which may never become operational. If expensed immediately, ratepayers would be burdened with paying for services which the utility may never provide.

Under this proposal, costs would accumulate in a deferred account until the software systems are examined in a general rate proceeding. Those software systems used for new regulatory services would be capitalized, amortized over the system's projected life, and recoverable in rates. However, those software systems abandoned or utilized in offering an unregulated service would be recorded as a non-operating expense and not be recoverable through the rate making process, irrespective of their prudency.

Pacific Bell believes that DRA's proposal is not appropriate because new software under development for future revenue-generating services is not addressed in Part 32 and because there is no significant change to the current method of accounting for software costs. Further, the deferred method for Pacific Bell's pending 800 service was adopted only after the specific service was scrutinized by all interested parties in a Commission proceeding.

The utilities are concerned that under Amato's proposal they will bear all the risk of the development of new software and pass on all the benefits of the development to the ratepayers. This is because Amato recommends that, although a return is to accumulate with the software development cost, recovery would not occur until a new regulated service is offered and the prudency of such costs are scrutinized for reasonableness in a rate proceeding. Further, if a new regulated service is not implemented, the utilities would not be allowed to recover their development cost, no matter how prudent the costs are.

Although the telecommunications industry is in a dynamic era with the increased presence of innovative technology and competition, telephone utilities are not research or development companies. Not even Pacific Bell's software development for its proposed 800 service is being undertaken by Pacific Bell; it is being undertaken by an unregulated affiliate, Bell Communications Research, Inc.

Ratepayers should not be required to compensate utilities for software development costs intended for future revenue-generating services without a mechanism to review the intergenerational equities or the prudency of such costs. Currently, this review is conducted in general rate proceedings on a case-by-case basis as, for example, Pacific Bell's software development costs for 800 service.

As the utilities assert, Part 32 does not substantially depart from the current method of accounting for software development costs. However, DRA proposes the implementation of a blanket cost deferral until the service is being offered as a regulated service or abandoned, a retrospective review.

Part 32 does not substantially change the accounting for software costs from the current accounting procedure as shown on pages 3-9 of DRA's Exhibit 2. We will continue to address software development costs for future revenue-generating services on a case-by-case basis.

i. Depreciation

Part 32 affects the depreciation accrual to the extent that certain asset groups, such as computer and central office equipment - toll, will be reclassified from one depreciation category to another. This reclassification of categories will change the remaining life of the categories, the reserve balance of the existing categories and the depreciation accrual for those categories.

DRA's witness, Joshi, recommends that any revenue requirement resulting from the accrual change be charged to a deferred account until the accrual reaches a cross-over point, negating the revenue requirement. This recommendation is made even though DRA and respondent utilities project that revenue requirement changes associated with the changes to depreciation categories will be minimal.

According to DRA, any changes in depreciation would be revenue neutral until there is a represcription of depreciation rates. Such represcription is expected to take place in 1988 for Pacific Bell and 1990 for GenTel. Therefore, we conclude that rather than requiring the utilities to implement a procedure to track nominal depreciation changes that may occur in 1988 for Pacific Bell and 1990 for GenTel, such revenue requirements, if any, should be addressed during the represcription of the utilities' depreciation rates.

j. Comprehensive Normalization

The issue of comprehensive normalization was initially raised by Pacific Bell, GenTel, and AT&T because the FCC's Part 32 requires that the tax effect of book and tax timing differences be normalized. Comprehensive normalization is an accounting concept that matches all income tax effects with the underlying transactions in the accounting period in which the transactions are reported in the utility's income statement.

Should comprehensive normalization for income taxes be adopted, Pacific Bell's and GenTel's revenue requirement would be immediately reduced by $46 million and $6 million, respectively. Five years later, in 1993, Pacific Bell's revenue requirement would be increased $3 million and GenTel's decreased by $3 million. There would be a minimal impact, if any, on AT&T and the smaller independent telephone companies.

Prior to The Tax Reform Act of 1986, construction overheads were capitalized for accounting and ratemaking purposes as components of construction-work-in-progress (CWIP). However, for accounting and ratemaking purposes these overhead components were deductible currently for federal tax purposes. The federal tax benefits derived from taking the overhead components capitalized as a deduction for federal tax purposes were flowed through to the ratepayers for ratemaking purposes. This policy resulted in a lesser ratemaking federal tax expense than what it would have been if the overheads had been considered capitalized components of CWIP for federal tax purposes and normalized.

Subsequent to the passage of The Tax Reform Act of 1986, construction overheads that were previously deductible in arriving at federal tax must now be capitalized in CWIP as a construction component for federal tax purposes.

Part 32 requires overheads previously capitalized to be expensed raising the issue of normalization versus flow-through. Under normalization, the difference between expensing overheads currently and the accelerated depreciation available for Federal tax purposes would be multiplied by the statutory corporate tax rate and reflected as a deferred tax. In other words, the company would take the deduction currently instead of capitalizing it and amortizing the deduction. Since the accounting and ratemaking treatment of overheads as expense has a greater effect on reducing taxable income than does the deduction of accelerated depreciation on a tax return basis, the deferred tax generated by this timing difference would be added to rate base.

Under flow-through, the ratemaking Federal tax expense is higher than under normalization because the current deduction of overheads for the Federal tax calculation is replaced with the accelerated depreciation available on the capitalized overheads on a tax return basis.

An ancillary issue pending before the Internal Revenue Service (IRS) is an industry wide application for a "change in accounting method." If IRS approves the request, federal tax treatment would generally be consistent with the capitalization requirements of Part 32. However, if it isn't approved, the utilities would be required to continue capitalizing for federal tax purposes the overhead components expensed under Part 32. Pacific Bell estimates an additional revenue requirement of $2 million if the accounting change for tax purposes is not approved.

The utilities recommend tax normalization because it conforms with GAAP, it results in a lower revenue requirement, and it eliminates excessive record keeping requirements.

DRA recommends the continuation of flow-through because it is consistent with current Commission policy, because the Federal tax law is highly volatile with frequently changing requirements, and because normalization would only benefit the ratepayer in the short-term.

The issue of normalization versus flow-through was addressed by the Commission in D.84-05-036 (OII 24). Upon review of a comprehensive analysis of all California utilities, the decision affirmed that the flow-through treatment of timing differences is to continue as Commission policy.

Although The Tax Reform Act of 1986 substantially eliminates the tax benefits that were flowed through to the ratepayers from the overhead components previously capitalized but deductible for tax purposes, the treatment may be short lived because additional changes to the tax code are under consideration. A change in policy at this time may not be warranted because of the volatility of the recent tax changes and short-term impacts.

We concur with DRA's analysis that the Federal tax law is volatile and that normalization would only benefit the ratepayers in the short-term. A substantial amount of time and analysis went into our affirmation of a generic flow-through policy. The telephone utilities have not convinced us that the generic policy should be modified for telephone utilities. Therefore, the policy of flowing through tax benefits should continue as a generic ratemaking policy and the telephone utilities should continue, as they have in the past to maintain memorandum records reflecting the accounting for both flow-through and normalization of taxes.

k. Future GAAP

Part 32 adopts future GAAP pronouncements automatically, unless the FCC notifies the telephone utilities to the contrary. However, DRA recommends that future GAAP pronouncements should be adopted by this Commission only after the major utilities (Pac Bell, GenTel, AT&T, ConTel, Roseville and Citizens) provide a positive showing to the Commission that such pronouncements are for the good of the ratepayers. To accomplish this positive showing DRA recommends that:

a. This investigation be kept open to address future GAAP changes.

b. Telephone utilities' Part 32 petitions and/or revenue requirements filed with the FCC should be filed concurrently with this Commission. Copies are to be sent to both DRA and CACD.

c. For GAAP changes, revenue impact studies are to be provided to DRA and CACD within 90 days after the FASB releases its final pronouncement.

d. For Part 32 changes initiated by the FCC, FCC required studies should be filed in accordance with item b.

e. Non-revenue items be addressed as supplements to this investigation on a periodic basis as necessary.

GenTel concurs with DRA's proposal because it believes that FASB's GAAP changes will be relatively infrequent.

We concur with DRA that future GAAP pronouncements should not be routinely adopted. However, this investigation should not be kept open for an indefinite period of time. Rather, the

Commission's Resolution procedure should be used to address subsequent Part 32 changes. Should a controversial issue occur, a new investigation could be opened to considered the matter based on an evidentiary record.

The following telephone utilities, Pacific Bell, GenTel, AT&T, ConTel, and Citizens should provide the following to both DRA and CACD Directors:

a. Concurrent copies of any Part 32 petition and/or revenue requirement filed with the FCC.

b. For GAAP changes, revenue impact studies within 90 days after the FASB releases its final pronouncement.

c. For Part 32 changes initiated by the FCC, FCC required studies concurrent with their FCC filing.

Roseville should not be included because, unlike the other telephone utilities, its revenue requirement impact from adoption of Part 32 and Part 36 is nominal.

With the foregoing discussions GAAP as modified by this opinion should be adopted. Any revenue requirement impacts should be accounted for in a manner consistent with the treatment for capital to expense charges identified in this decision.

VII. Post Retirement Benefits

AT&T and ConTel recommend the adoption of a change in accounting for post retirement benefits from the cash basis of accounting to the accrual basis. Post retirement benefits will change from being recorded as an expense when actually paid to being an expense which is accrued and recorded when earned. ConTel took its recommendation one step further by adopting this accounting change for its accounting records effective 1987.

Both AT&T and ConTel recommend this change in accounting on the premise that the FASB is expected to issue an exposure draft on converting to the accrual method for post retirement benefits sometime next year. An exposure draft is a proposal for a GAAP sent out by FASB for comments by all parties prior to adoption.

DRA asserts that adoption of this accounting change by FASB is purely conjectural at this time. Even if an exposure draft is issued next year, it is not currently known what actuarial methodology may be required or accepted by the FASB. Further, once an exposure draft is issued, there is generally a lengthy period of time before the FASB issues a final pronouncement. For example, a FASB exposure draft on accounting and reporting by defined benefit pension plans issued in April 1977 was adopted nine years later.

We concur with DRA. This investigation was opened to consider whether GAAP should be adopted for accounting purposes, and if so, to what extent, not to speculate on future GAAP pronouncements. The accrual method of accounting for post retirement benefits should not be adopted at this time. Further, ConTel should change its accounting records for Commission purposes to conform with the cash basis of accounting for post retirement benefits.

VIII. Prior Ratemaking Policies

DRA, concerned that the adoption of Part 32 may have unforseen side effects of eradicating prior Commission decisions and policies adopted over the years, recommends that if any such issue arises, it be addressed in each utility's general rate proceeding. Further, adoption of Part 32 should not be considered a reason for any telephone utility to abandon accounting and ratemaking requirements instituted by this Commission in past proceedings. To the extent that such accounting and ratemaking changes are not specifically addressed in this opinion, we concur.

In this investigation Pacific Bell and DRA have identified a prior Commission policy pertaining to the accounting for affiliated company transactions which needs to be modified because in its present form it renders compliance under Part 32 impossible.

By D.86-01-026 Pacific Bell was required to record all transactions with affiliated companies in Account 674, General Services and Licenses. Although not specifically ordered to do so, GenTel and ConTel also use Account 674 to record transactions with affiliated companies.

Under Part 32 accounting, affiliated company transactions will be disaggregated to several different Part 32 accounts based on the nature of the affiliate transactions. There will be no account similar to the current General Services and Licenses expense account. However, Pacific Bell and DRA developed a procedure to provide the Commission with the necessary information to oversee and analyze affiliated company transactions. This agreed upon procedure between Pacific Bell and DRA should be used by any telephone company involved in affiliate company transactions. The procedure is as follows:

a. Within each Part 32 account in which affiliate costs are assigned, a separate and unique subaccount code is to be set up to record the affiliate costs chargeable to that account.

b. Affiliate company subaccount codes are to be used exclusively to record affiliate company costs.

c. The cumulative total recorded in affiliate company subaccounts' codes for a period must reconcile with the affiliate company billing for that period.

d. Subsidiary records to support the monthly affiliate billings are to be set up and maintained, with such records providing an audit trial to the Part 32 account assigned affiliate costs and a year-to-date accumulation of the total costs billed by the affiliate.

e. Supplemental memorandum records are to be maintained for surveillance purposes to track Commission adopted affiliate company adjustments.

f. For rate proceedings, the utilities are to submit their test year affiliate company estimated costs separately.

IX. Separations

Telephone utilities provide both interstate and intrastate services subject to regulation by the FCC and this Commission, respectively. Therefore, it is necessary to allocate (separate) the utility's revenues, expenses, taxes, investments, and reserves between interstate and intrastate operations. This is accomplished through the use of a separations manual. For intrastate purposes this separations manual is used to determine the cost of services within the state, such as interLATA (Local Access and Transport Area) access, message toll, toll private line, and exchange service.

Currently, the FCC's Separations Manual (Part 67) is used by this Commission. However, this separations manual is structured by accounts identified in the FCC's current USOA. With the adoption of Part 32, to be effective January 1, 1988, the separations manual is obsolete. Accordingly, the FCC issued a new separations manual (Part 36) based on the new USOA, to be effective January 1, 1988.

GenTel and AT&T estimate nominal impacts from the adoption of Part 36. However, Pacific Bell initially estimated that adoption of Part 36 would result in an additional $28.6 million revenue requirement comprised of:

	Issue	Impact (Millions)
a.	Central Office Category 6	$ 5.4
b.	Central Office Category 8.23	(19.5)
c.	Revenue Accounting Expense	(23.7)
d.	Marketing Expense	62.5
e.	Other Conformance Issues	3.9
	Total Impact	$ 28.6

Part 36, in addition to conforming to Part 32, incorporates four separations rule changes. Of the four rule changes only one, the assignment of all marketing activities to the intrastate jurisdiction, has a significant impact on intrastate revenue requirements. As shown in the above tabulation, the allocation factor for marketing results in a $62.5 million revenue increase for Pacific Bell.

Although DRA's witness, Low, expresses caution in adopting the new marketing allocation factor, he does recommend adoption of Part 36 to the extent that it conforms with Part 32, as adopted in this investigation.

However, Low makes no recommendation on the revenue requirement effect of Part 36 because he has not yet analyzed separations data from the major utilities. According to Low, he needs at least 45 days to analyze Part 36 data from the major utilities before he can recommend whether the individual utility's revenue requirement is reasonable or not. Since he only received Pacific Bell's separations data in the first week of August and expected to receive ConTel's and GenTel's on August 15 and October 15, 1987, respectively, a DRA recommendation on revenue requirement impacts for Part 36 will not be available until at least January 1988.

Subsequent to the receipt of separations testimony, the FCC revised its allocation factor for marketing expenses to include access revenue, on an interim basis. The FCC is reviewing its marketing factor and intends to issue a permanent factor in intrastate jurisdiction, has a significant impact on intrastate revenue requirements. As shown in the above tabulation, the allocation factor for marketing results in a $62.5 million revenue increase for Pacific Bell.

Although DRA's witness, Low, expresses caution in adopting the new marketing allocation factor, he does recommend adoption of Part 36 to the extent that it conforms with Part 32, as adopted in this investigation.

However, Low makes no recommendation on the revenue requirement effect of Part 36 because he has not yet analyzed separations data from the major utilities. Accoding to Low, he needs at least 45 days to analyze Part 36 data from the major utilities before he can recommend whether the individual utility's revenue requirement is reasonable or not. Since he only received Pacific Bell's separations data in the first week of August and expected to receive ConTel's and GenTel's on August 15 and October 15, 1987, respectively, a DRA recommendation on revenue requirement impacts for Part 36 will not be available until at least January 1988.

Subsequent to the receipt of separations testimony, the FCC revised its allocation factor for marketing expenses to include access revenue, on an interim basis. The FCC is reviewing its marketing factor and intends to issue a permanent factor in April 1988. With this interim change in the marketing factor Pacific Bell's witness, Sawyer, testified that Pacific Bell's revenue requirement related to Part 36 should be reduced by $62.5 million, producing a negative $33.9 million requirement. DRA's major concern with the adoption of Part 36 is alleviated with the interim allocation factor.

During evidentiary hearings GenTel's counsel brought to the attention of all parties a recent Ninth Circuit Court of Appeals dcision (Hawaiian Telephone Company v. Public Utilities Commission, 827 F.2d 1264 (9th Cir. 1987) regarding the FCC's

April 1988. With this interim change in the marketing factor Pacific Bell's witness, Sawyer, testified that Pacific Bell's revenue requirement related to Part 36 should be reduced by $62.5 million, producing a negative $28.6 million requirement. DRA's major concern with the adoption of Part 36 is alleviated with the interim allocation factor.

During evidentiary hearings GenTel's counsel brought to the attention of all parties a recent Ninth Circuit Court of Appeals decision (Hawaiian Telephone Company v. Public Utilities Commission, 827 F.2d 1264 (9th Cir. 1987)) regarding the FCC's authority to determine separations procedures. This decision is being appealed by the Hawaiian Commission. By brief, DRA confirmed that it would not make any recommendations to modify the FCC's Part 36. However, DRA will review its position on modification of Part 36 after decision on the Hawaiian Commission's appeal. Meanwhile, DRA is reviewing the reasonableness of the revenue requirement impacts from adopting Part 36.

Disputes regarding the adoption of Part 36 have been resolved during the course of this investigation and all parties recommend adoption of Part 36. The one remaining issue, as pointed out by DRA, is the reasonableness of the individual utility's revenue requirement impact from adopting Part 36. However, since this investigation is not intended to change existing rates there is no need to determine the reasonableness of such revenue requirement at this time. Therefore, we adopt Part 36.

Consistent with the treatment of capital to expense impacts Pacific Bell, GenTel, Citizens, and ConTel should record the revenue requirement impact of adopting Part 36 in a balancing account. Supporting workpapers should be maintained for review until the balancing account is terminated. AT&T and the smaller independent telephone companies should address the revenue requirement impacts in their next general rate case or GO 96 filing, as appropriate.

a. <u>SPF to SLU</u>

One of the three minor separations rule changes relate to Central Office Category 6 (Category 6). Non Traffic Sensitive (NTS) costs associated with Category 6 will no longer be distinguished from traffic sensitive costs. This change will make it impossible to continue to apply a subscriber plant factor (SPF) to the subscriber line usage (SLU) to Category 6 for the purpose of shifting NTS costs from interexchange access services to exchange services. However, SPF to SLU will continue to apply to the majority of NTS costs.

A Dial Equipment Minutes (DEM) measurement replaces the SLU measurement, both of which measure the relative use of local switching equipment. To put this in perspective, Sawyer calculated Pacific Bell's DEM and SLU interLATA access factor for March 1987. The DEM measurement shows that 6.9% of all telephone call minutes on subscriber lines are from interLATA access calls and the SLU measurement shows 6.7%, or a 0.2% differential between DEM and SLU. This differential results from the inclusion of closed end WATS minutes in the DEM formula.

Pacific Bell recommends that the Part 36 DEM measurement should be used to determine the shift from access to exchange services and that the shift amounts using DEM be included for recovery in the annual SPF to SLU advice letter filing. GenTel concurs with Pacific Bell.

Since there is no opposition to Pacific Bell's proposal, the DEM measurement should be used in place of the current SLU measurement to determine shifts from access to exchange services for Category 6, only.

X. <u>Other Issues</u>

The investigation identifies other proceedings that are being undertaken by the FCC concurrent with Part 32. Two of these proceedings, Part 64 (commonly known as Part X) and Part 69 are addressed by DRA. Part 64 is a cost allocation standard for recording transactions between regulated telephone utilities and their corporate affiliates. Part 69 is revised access charge rules.

a. <u>Part 64</u>

DRA's witness, Lew, did not analyze the impact of Part 64 because the FCC was considering several petitions for reconsideration and because the utilities' cost allocation manuals were not yet finalized. Lew recommended that Part 64 be considered at a later date when more information and time is available. According to Lew, lack of a decision on Part 64 will not adversely affect the adoption of Part 32.

On the last day of evidentiary hearings, DRA's counsel informed all parties to the investigation that DRA is ready to proceed with Part 64 and requested that parties have their Part 64 testimony ready in December 1987. The telephone utilities objected to DRA's request because they believed that Part 64 is not a part of this investigation. The matter was deferred to briefs due on October 30, 1987.

DRA, concerned that the FCC has set January 1, 1988 to be the effective date of Part 64 for interstate purposes, recommends that the Commission address Part 64 by the end of 1987. According to DRA, it considered Part 64 to be an issue in this proceeding and believes that it should be considered with Part 32.

The utilities do not believe that it should be addressed in this investigation. Although Part 64 is identified in the investigation, similar to Part 69, it is only identified as one of the many changes occurring in the FCC rules.

This investigation was opened to specifically address Part 32, its effect on intrastate rates, and the ratemaking treatment of the implementation costs associated with Part 32.

DRA's own witness testified that lack of a decision on Part 64 will not affect the adoption of Part 32.

Part 64 is not specifically identified as an issue in this investigation. Further, the investigation is not intended as a "catch-all" to address ancillary matters. To keep it open at this time would require us to expand the investigation and to notify prospective interested parties of our intentions. We conclude that Part 64 should not be addressed in this investigation.

However, since the Commission currently does not have a method for utilities to allocate costs between regulated telephone utilities and their corporate affiliates, it may best to institute a proceeding to consider the FCC's Part 64. Such a proceeding should be considered by CACD and if warranted, proposed to us in a new investigation.

b. Part 69

Part 69 is another ancillary matter discussed by DRA. However, in this instance DRA believes that because Part 69 is not intended to have an impact on intrastate ratemaking under current conditions, it need not be addressed. However, DRA does recommend that Part 69 be reviewed after the FCC issues its final report and order to verify that it will not affect intrastate ratemaking. Part 69 should not be considered at this time.

XI. Impacts

The adoption of Part 32 and Part 36 with modification will have the largest revenue requirement impact on Pacific Bell, GenTel, AT&T, Citizens, and ConTel. Based on incomplete estimates of the utilities which have not been examined, Pacific Bell will incur an additional revenue requirement of approximately $128 million in 1988, GenTel $46 million, AT&T and Citizens $2 million, and ConTel $1 million. The approximate impact on Pacific Bell and GenTel as a result of this decision are set out below:

Item	Pacific Bell	GenTel
	(Millions of Dollars)	
Capital to Expense Shifts	$ 118	$ 46
GAAP Shifts		
Leasehold Improvements	10	NA
Compensated Absences	19	NA
Workers' Compensation	6	NA
Incentive Awards	9	NA
Separations	(34)	NA
Total	$ 128	$ 46

(NA = Not Available)

We stress that these figures are preliminary and are based on the estimates furnished by Pacific Bell and GenTel.

XII. Balancing Account

The next issue we need to address is the method utilities should use to recover the revenue requirement impacts caused by the adoption of Part 32 and Part 36.

DRA does not believe that current ratepayers should be required to compensate the utilities for the capital to expense accounting change because the utilities will not incur any additional out of pocket cost; they will incur only "paper" costs. Further, DRA contends that it is future ratepayers who are to benefit from the resulting decrease in revenue requirement.

DRA proposes that the additional revenue required from this accounting change be charged to a deferred account on a yearly basis until a cross-over point is reached and the revenue requirement from the capital to expense shift becomes negative.

conclude that Part 64 should not be addressed in this investigation.

However, since the Commission currently does not have a method for utilities to allocate costs between regulated telephone utilities and their corporate affiliates, it may best to institute a proceeding to consider the FCC's Part 64. Such a proceeding should be considered by CACD and if warranted, proposed to us in a new investigation.

b. Part 69

Part 69 is another ancillary matter discussed by DRA. However, in this instance DRA believes that because Part 69 is not intended to have an impact on intrastate ratemaking under current conditions, it need not be addressed. However, DRA does not recommend that Part 69 be reviewed after the FCC issues its final report and order to verify that it will not affect intrastate ratemaking. Part 69 should not be considered at this time.

XI. Impacts

The adoption of Part 32 and Part 36 with modification will have the largest revenue requirement impact on Pacific Bell, GelTel, AT&T, Citizens, and ConTel. Based on incomplete estimates of the utilities which have not been examined, Pacific Bell will incur an additional revenue requirement of approximately $118 million in 1988, GelTel $46 million, AT&T and Citizens $2 million, and ConTel $1 million. The approximate impact on Pacific Bell and GelTel as a result of this decision are set out below:

The surplus received should then be offset against the accumulated balance until the deferred account reaches zero. Concurrently, DRA proposes that the telephone utilities should be required to maintain subsidiary records so DRA could analyze the activity related to each individual capital to expense shift during the period when the deferred account is needed. DRA's witness, Woods, recommends that the smaller independent telephone utilities be exempt from using a deferred account because their additional revenue requirement associated with this accounting change are nominal.

DRA's witness recommends that a deferred account be implemented using existing utility estimates of the capital to expense shifts rather than actual dollar amounts because the utilities would have difficulty in identifying and tracking the changes without maintaining a complete separate set of records. These estimates are to be audited by DRA on a yearly basis, prior to the utilities recording their estimates in the deferred account. The authorized rate of return will be applicable to the accumulated balance of the deferred account, resulting in a recovery mechanism similar to rate base.

The utilities object to DRA's proposal because it requires the utilities to estimate and maintain subsidiary records showing the development of approximately twenty individual capital to expense items and requires the utilities to estimate and document yearly rates of growth or decline, associated depreciation rates, construction expenditures, wage escalation factors, rate of return, and net-to-gross multipliers for at least twenty years.

We do not believe the utilities should be committed to such a long-term recovery of cost. Such a procedure would not only result in additional cost on the part of the utilities and additional auditing work for DRA but could result in disputes and in lengthy proceedings regarding the detail of subsidiary records, assumptions utilized, and inconsistent treatment among utilities.

Not only would the utilities be required to maintain a detailed set of records for approximately twenty years, the total cost to the ratepayers and the time lag before the deferred account is depleted would more than double the amortization period because of the imputation of a return to the accumulated deferred account balance. We concur with the utilities objections to DRA's proposal and we will not adopt it.

Pacific Bell, Citizens, and ConTel propose that a balancing account mechanism be adopted. They believe that such a mechanism is equitable to both present and future ratepayers, and to the utilities, while avoiding a dramatic increase in the record keeping burden and expense of the utility. Under this proposal, the revenue requirement impacts of this accounting change and other impacts from this investigation are to be placed into a balancing account with the impacts of other current proceedings, such as the Tax OII (I.86-11-019) and the triennial represcription.

The balancing account concept has merit and should be considered. However, there is one important factor which the parties appear to have overlooked. That is, the balancing account proposal assumes a guaranteed recovery of cost.

Historically, this Commission sets rates which provide utilities an opportunity to recover their costs and to earn a fair return on their investment; utilities are not, as parties propose in this instance, guaranteed recovery of costs. If the telephone utilities implement a new maintenance program designed to reduce future maintenance costs, such costs would be recoverable through the traditional trending procedures used for ratemaking purposes. Adoption of a change in accounting should not be treated any differently.

However, we recognize that the changes occasioned by our adoption of Parts 32 and 36 are substantial and at this point the utilities' and DRA's estimates of the revenue requirement effects of these changes is necessarily preliminary. We will therefore establish a balancing account for those utilities which have substantial revenue requirement impacts: Pacific Bell, GenTel, Citizens, and ConTel. The balancing account will be established for a limited period of time, not to exceed one year, and it will bear interest at the 90-day commercial paper rate consistent with our other balancing accounts.

This procedure will provide a temporary vehicle to isolate the effects of the USOA changes for DRA to examine and assess the reasonableness of the utilities' estimates of the revenue requirement impacts. For that reason, the balancing account should be separate from any other balancing account the Commission may authorize and should only include revenues and expenses resulting from the USOA changes adopted in this decision.

We expect to terminate this balancing account and to place the account balances in rates (along with other revenue requirement changes resulting from the Tax Reform Act of 1986, the inside wiring investigation, Pacific Bell's 1988 attrition and General Telephone's final decision in its general rate case) not later than January 1, 1989 and quite possibly sooner, in conjunction with our decisions in our investigation into rate flexibility, I.87-11-____ instituted on November 25, 1987. We will issue further orders disposing of the balancing account in that proceeding.

Those utilities implementing a balancing account should file a summary of their balancing account as of February 28, 1988 in original and 12 copies with the Commission's Docket Office on or before March 21, 1988. Concurrently, copies of the filing should be mailed to all parties to this proceeding and detailed supporting workpapers should be provided to DRA. The utilities should provide copies of the detailed supporting workpapers to all other parties requesting such documentation.

A report on the reasonableness of the individual utility's balancing account should be filed with the Commission's

Docket Office by DRA and any other interested party on or before April 20, 1988, with copies served on all parties.

GenTel proposes that it be allowed to recover its increased revenue requirement through its pending rate proceeding, Application (A.) 87-01-002. However, because all the revenue requirement impacts have not been quantified and scrutinized by DRA or other interested parties such a proposal should not be adopted at this time.

Since AT&T and the smaller independent telephone companies will incur minimal revenue requirement impacts, such impacts should be addressed in their next general rate case or General Order (GO) 96 filing as appropriate.

Findings of Fact

1. This investigation was opened to determine if Part 32 should be adopted for telephone utilities subject to the Commission's jurisdiction.

2. The FCC's USOA has previously been adopted by this Commission with modifications because of our desire to simplify and coordinate the accounting and reporting requirements imposed on telephone utilities operating under the jurisdiction of both this Commission and the FCC.

3. The FCC issued Part 32 because it believes that the present USOA is archaic and incapable of providing for changes in a complex, competitive, technological, and economic environment.

4. Part 32 is to be effective January 1, 1988 for telephone utilities under the FCC jurisdiction.

5. FASB 87 is not addressed in this opinion but will be the subject of an opinion in January, 1988.

6. Full adoption of Part 32 and Part 36 will result in additional revenue requirements for the telephone utilities in the short-term.

7. Pacific Bell estimates an additional revenue requirement of $82 million in 1988, GenTel $66 million, AT&T and Citizens $2 million, and ConTel $1 million.

8. Nominal impacts are estimated for the smaller independent telephone utilities.

9. DRA has not examined the reasonableness of the utilities estimates.

10. Present intrastate operations of telephone utilities, except AT&T, are approximately 80%. AT&T's is approximately 60%.

11. No projections of intrastate operations under Part 36 were provided because of ongoing modifications by the FCC.

12. PU Code § 793 requires the system of accounts and the forms of accounts, records, and memoranda prescribed by the Commission for corporations subject to the regulatory authority of the United States to not be inconsistent with the system and forms established for such corporations by or under the authority of the United States.

13. Parties to this investigation agree that Part 32 should be adopted.

14. DRA requests that the major utilities use one of DRA's four approaches identified in Chapter 7 of DRA's Exhibit 2 to restate 1987 data into Part 32 data.

15. DRA requests that the Commission's timetable established for the Rate Case Plan be extended one month to provide DRA additional time to coordinate with the utilities to understand Part 32 accounting requirements.

16. A majority of the respondent utilities recommend that the cost to implement Part 32 should be allocated between interstate and intrastate ratepayers.

17. Implementation costs are virtually all 1987 expenses and are recoverable through the separations process.

18. Part 32 requires indirect construction costs currently capitalized to be expensed.

19. The capital to expense shift will increase utilities' revenue requirements in the short-term. In the long-term this accounting change will result in revenue requirement savings.

20. All parties to this investigation concur that the capital to expense shift required by Part 32 be adopted for accounting and ratemaking purposes.

21. Part 32 adopts GAAP for accounting purposes to the extent regulatory considerations permit.

22. Part 32 adopts future GAAP changes automatically, unless the FCC notifies the telephone utilities to the contrary.

23. In those instances where GAAP permits more than one accounting method, the FCC will select the appropriate accounting method for use by the telephone utilities.

24. The adoption of GAAP changes will impact the utilities' revenue requirement similar to the adoption of the capital to expense shifts.

25. DRA recommends adoption of all GAAP changes with no revenue impact and adoption or modification of most of the remaining FCC adopted GAAP items having major revenue impacts.

26. DRA recommends GAAP be adopted for accounting purposes, however, DRA is silent on the ratemaking treatment.

27. The Commission's IDC formula is based on sound principles and has withstood litigation in several rate proceedings.

28. DRA does not object to the FCC selecting the appropriate accounting treatment in those instances where GAAP permits more than one accounting method.

29. All parties concur with Part 32's requirement that all leasehold improvements are to be capitalized separately and amortized over the term of the lease. Part 32 is silent on the treatment of embedded leasehold improvements.

30. GAAP requires compensated absences to be recorded as an expense in the year the liability is incurred.

31. GAAP requires the expected workers' compensation liability to be calculated and accrued as an expense in the current year.

32. GAAP requires incentive awards to be recorded on an accrual basis.

33. Contrary to the Commission's generic policy of requiring gains and losses from the early extinguishment of debt to be amortized over the life of the replacement debt, GAAP requires the gains and losses to be recognized as income or expense in the year of occurrence.

34. Part 32 does not substantially depart from the current accounting procedure for computer software development costs.

35. Computer software development costs intended for future revenue-generating services are currently reviewed on a case-by-case basis in general rate proceedings.

36. New software under development for future revenue-generating services is not addressed in Part 32.

37. Adoption of Part 32 requires the depreciation category of certain asset groups to change. This change results in the remaining life and depreciation accrual of the affected categories changing. The revenue requirement is nominal.

38. The utilities recommend tax normalization because it conforms with GAAP, results in a lower revenue requirement, and eliminates excessive record keeping.

39. DRA recommends the continuation of flow-through because it is consistent with current Commission policy, the Federal tax law is volatile, and normalization would only benefit the ratepayer in the short-term.

40. The issue of normalization versus flow-through was addressed as a generic policy in D.84-05-036.

41. The automatic adoption of future GAAP pronouncements is not in the best interest of the ratepayers.

42. A change in accounting for post retirement benefits from a cash basis of accounting to a accrual basis on the belief that the FASB is going to issue an exposure draft requiring the accrual method of accounting to be used is speculative.

43. Pacific Bell and DRA have developed a procedure to provide the Commission with necessary information to oversee and analyze affiliated company transactions.

44. The current separations manual is obsolete because it is structured by accounts identified in the current USOA.

45. Part 36 is structured by accounts identified in Part 32 and incorporates four rule changes.

46. All parties to the investigation recommend that Part 36 be adopted.

47. DRA has not analyzed the reasonableness of the utilities Part 36 revenue requirements.

48. One of the Part 36 rule changes require a DEM measurement replace the SLU measurement to determine shifts from access to exchange services for Category 6.

49. NTS costs associated with Category 6 will no longer be distinguished from traffic sensitive costs making it impossible to continue to apply a SPF to SLU factor to Category 6.

50. SPF to SLU is to continue to apply to the majority of NTS costs.

51. Part 64 and Part 69 are not identified as issues in this investigation.

52. The utilization of a deferred account to record the additional revenue requirement from the capital to expense change until the cross-over point is reached, and the revenue requirement becomes negative would require the utilities to estimate and maintain subsidiary records showing the development of approximately twenty individual items. The utilities would also be

required to estimate yearly rates of growth or decline, associated depreciation rates, construction expenditures, wage escalation factors, rate of return, and net-to-gross multipliers.

53. Use of a deferred account for revenue requirement impacts of capital to expense shifts would be costly.

54. Use of a balancing account on a temporary basis for revenue requirement impacts of capital to expense shifts will avoid an increase in the utilities' record keeping burden and expense, will provide a vehicle to isolate USOA impacts for further examination by DRA and enable the utilities to combine revenue requirement impacts of other proceedings before the Commission in rates at one time.

55. This investigation specifically states that while this opinion may have an impact on future ratemaking, in and of itself, it will not change existing rates.

56. There is no Commission intent to "guarantee" telephone utilities recovery of all costs associated with the adoption of Part 32.

57. Utilities are entitled an opportunity to recover the additional revenue requirement impact from Part 32.

58. GenTel requests that it be allowed to recover its revenue requirement impacts through its pending rate proceeding.

<u>Conclusions of Law</u>

1. FASB 87 should be addressed in a subsequent opinion in January 1988, because of the substantial amount of testimony received and the substantial amount of discussion in the interested parties' briefs filed October 30, 1987.

2. The telephone utilities' percentage of intrastate operations should not change with the adoption of Part 36.

3. PU § 793 and § 794 do not preclude the Commission from prescribing forms of accounts, records, and memoranda covering information in addition to that required by or under the authority of the United States.

4. The issue of whether PU Code § 793 requires the Commission to adopt Part 32 is moot since all parties to the investigation recommend that Part 32 be adopted.

5. A Commission order requiring major telephone utilities to provide DRA with 1987 data based on Part 32 should not be necessary because the major utilities have agreed to provide the data.

6. The Rate Case Plan timetable should not be extended an additional month because of the adoption of Part 32 because the entire schedule is under investigation in another proceeding.

7. Part 32 should be adopted to the extent provided by this opinion.

8. Part 32 implementation cost should be recoverable in the same manner as other operating expenses through the general ratemaking process and settlement pools.

9. Part 32 capital to expense shifts should be adopted for accounting and ratemaking purposes, to the extent that they do not conflict with Commission ratemaking policies discussed in this opinion.

10. The implementation of a deferred account to record the revenue requirements associated with Part 32 capital to expense shifts should not be adopted.

11. This investigation was not opened to change existing utility rates, therefore, the utilities which have substantial revenue requirement impacts (Pacific Bell, GenTel, Citizens, and ConTel) from the adoption of Part 32 should be allowed an opportunity to recover their additional revenue requirement through the use of a balancing account for a period not to exceed one year.

12. The impact of GenTel's balancing account should not be addressed in the rate design phase of GenTel's pending rate proceeding until it has been audited by DRA.

13. By March 21, 1988, those utilities implementing a balancing account should file a summary of their balancing account as of February 28, 1988 with the Commission's Docket Office. DRA

and any other interested party should file a report on the reasonableness of the balancing accounts by April 20, 1988.

14. Part 32 impacts on AT&T and the smaller telephone utilities should be addressed in their next general rate proceeding or GO 96 filing.

15. GAAP as modified by this opinion should be adopted. Any revenue requirement impacts should be accounted for in a manner consistent with the treatment of capital to expense changes identified in this opinion.

16. The telephone utilities should continue to maintain appropriate accounting and ratemaking records to conform with the Commission's IDC formula.

17. Where GAAP permits more than one accounting method the utilities should use the method selected by the FCC. However, should any party object to the method selected by the FCC, that party should bring the issue before the Commission in a formal proceeding.

18. Leasehold improvements should be capitalized separately and amortized over the term of the lease. Embedded leasehold improvements should continue to be amortized over the life of the buildings account.

19. GAAP accounting for compensated absences and workers' compensation should be adopted.

20. GAAP accounting for incentive awards should be adopted. Any awards accruing for employees terminating service during the year and not receiving the award should be reversed.

21. Gains and losses from the early extinguishment of debt should be amortized over the life of the replacement debt.

22. The Commission's Resolution procedure should be utilized to address subsequent Part 32 changes.

23. The accrual basis of accounting for post retirement benefits should not be adopted.

24. Computer software development costs for future revenue-generating services should continue to be addressed on a case-by-case basis.

25. Part 32 asset groups for depreciation should be adopted. Any changes in depreciation because of the reclassification of certain asset groups should be addressed during the utilities represcription of depreciation rates.

26. Telephone utilities should not abandon any accounting and ratemaking requirements instituted by this Commission in past proceedings unless changes were specifically discussed in this decision.

27. The utilities should use the procedures developed by Pacific Bell and DRA to account for and to track affiliated company transactions.

28. Part 36 should be adopted. Any revenue requirement impact should be treated similarly to the capital to expense revenue requirement impacts. Supporting workpapers should be maintained for review by the Commission's DRA.

29. The DEM measurement should be used in place of the current SLU measurement to determine shifts from access to exchange services for Category 6, only.

30. Part 32 comprehensive normalization for income taxes should not be adopted. Flow-through of income taxes should continue.

31. Part 64 and Part 69 should not be addressed in this investigation.

32. Part 32 and Part 36 as modified by this opinion should be effective January 1, 1988 to conform with the FCC's implementation date of Part 32 and Part 36.

INTERIM ORDER

IT IS ORDERED that:

1. The Federal Communications Commission's (FCC) Part 32, Uniform System of Accounts for Telephone Corporations, is adopted to the extent provided in the above opinion and shall be applicable to all telephone utilities under the Commission's jurisdiction.

2. The FCC's Part 36, Separations Manual, is adopted and shall be applicable to all telephone utilities under the Commission's jurisdiction.

3. Costs incurred to implement Part 32 shall be recoverable in the general ratemaking process and settlement process, similar to the recovery of other operating expenses.

4. Pacific Bell, General Telephone Company of California, Citizens Utilities Company of California, and Continental Telephone Company of California are authorized to initiate a balancing account on their books of account to record revenue requirement impacts from the adoption of Part 32 and Part 36. The balancing account shall bear interest at the 90-day commercial paper rate.

5. Utilities implementing a balancing account shall file a summary of their balancing account as of February 28, 1988 with the Commission's Docket Office and shall serve copies on all interested parties on of before March 21, 1988.

6. The Commission's Division of Ratepayer Advocates and any other interested party shall file a report of the reasonableness of the utilities' balancing account on or before April 20, 1988.

7. The balancing account shall terminate no later than January 1, 1989 in connection with our investigation into regulatory flexibility instituted November 25, 1987 (I.87-11-____).

8. Revenue requirement impacts from adoption of Part 32 and Part 36 on all other telephone utilities shall be addressed in their next general rate proceeding or General Order 96 filing.

9. The telephone utilities shall continue to maintain appropriate accounting and ratemaking records to conform with the Commission's Interest During Construction formula for construction projects.

10. The telephone utilities shall continue to conform with the Commission's policy of amortizing gains and losses from the early extinguishment of debt over the life of the replacement debt.

11. The Commission's advice letter procedure shall be used to address subsequent Part 32 changes.

12. Regarding Part 32 changes, major telephone utilities (Pacific Bell, General Telephone Company of California, AT&T Communications of California, Inc., Continental Telephone Company of California, and Citizens Utilities Company of California) shall provide to the Commissions Division of Ratepayer Advocates and Commission's Advisory and Compliance Division Directors:

a. Concurrent copies of any Part 32 petition and/or revenue requirement filed with the FCC.

b. For GAAP changes, revenue impact studies within 90 days after the FASB releases its final pronouncement.

c. For Part 32 changes initiated by the FCC, FCC required studies concurrent with their FCC filing.

13. Computer software development costs for future revenue-generating services shall continue to be addressed on a case-by-case basis.

14. Telephone utilities engaged in affiliated company transactions shall conform to the affiliated company transaction procedures developed by Pacific Bell and DRA as follows:

a. Within each Part 32 account assigned affiliate costs, a separate and unique subaccount code shall be set up to record the affiliate costs chargeable to that account.

b. Affiliate company subaccount codes shall be used exclusively to record affiliate company costs.

c. The cumulative total recorded in affiliate company subaccounts' codes for a period shall reconcile with the affiliate company billing for that period.

d. Subsidiary records to support the monthly affiliate billings shall be set up and maintained with such records providing an audit trial to the Part 32 account assigned affiliate costs and a year-to-date accumulation of the total costs billed by the affiliate.

e. Supplemental memorandum records shall be maintained for surveillance purposes to track Commission adopted affiliate company adjustments.

f. For rate proceedings, the utilities are to submit their test year affiliate company estimated costs separately.

15. The Dial Equipment Minutes measurement shall be used in place of the current Subscriber Line Usage measurement to determine shifts from access to exchange services for Central Office Category 6, only.

16. The Commission's Advisory and Compliance Division shall review the FCC's Part 64 and Part 69, when available, and report to the Commission whether an investigation should be opened.

17. This proceeding remains open for further decision on FASB 87.

This order is effective today.

Dated ____________________, at San Francisco, California.