Decision 87-12-067 December 22, 1987

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of PACIFIC BELL, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application 85-01-034 (Filed January 22, 1985; amended June 17, 1985 and May 19, 1986)
	I.85-03-078 (Filed March 20, 1985)
	OII 84 (Filed December 2, 1980)
	C.86-11-028 (Filed November 17, 1986)

(See Decisions 85-08-047 and 86-01-026 for appearances and Appendix A for additional appearances.)

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SECOND INTERIM OPINION ON PACIFIC BELL'S REVENUE REQUIREMENT

I. Summary of Decision

Today's decision identifies test year revenue requirements reductions of $86,435,000 resulting from our review of several outstanding Phase 2 issues. However, many of the Phase 2 adjustments relate back to March 5, 1986 (and, in some cases intervening dates), as shown in more detail in Table 1, Section XVI, infra. Thus this Phase 2 decision actually results in a $194.471 million intrastate revenue requirement reduction, which we implement by modifying the existing surcharges, effective January 1, 1988, as more fully discussed in Section XVI infra. A separate rate design decision will be issued subsequently in this proceeding.

The Separated Results of Operations and revenue requirement calculations associated with the $86.435 million reduction are shown in Appendix B hereto. When the $86.435 million reduction is added to the negative $120,649,000 revenue requirement determined in Phase 1 (D.86-03-049), the total intrastate revenue requirement for Test Year 1986 is ($208,153,000).

In today's decision we dispose of several issues carried forward from Phase 1 of this proceeding, summarized below:

We adopt arguments favoring an interest synchronization adjustment which has a ($28.653) million impact on the test year revenue requirement (Section IV, infra).

Addressing the marketing abuse issue, (Section V, infra), we order Pacific Bell to undertake a second notification and refund campaign, in consultation with workshop participants; as with the first refund campaign, all costs of the second effort will be borne by Pacific Bell's shareholders. We also require continuation of the workshop/CNP mechanism until further order.

In lieu of the penalties recommended by several parties, we order Pacific Bell to set aside $16.5 million of shareholder assets to fund a ratepayer education trust fund, with a goal of disbursing $3 million annually, to promote ratepayer education efforts, over the next five years. We also provide a mechanism for the active parties to work together to refine the precise details of the trust fund, including the issue of membership of the disbursements committee. We do this in recognition of the fact that these specific matters were not addressed by the active parties earlier in the proceeding.

We also order establishment of a Customer Marketing Oversight Committee (in accordance with past decisions addressing the marketing abuse issue). We further order revisions to Tariff Rule 12 and the filing of an advice letter to implement itemized billing for Pacific Bell's business customers.

We approve Pacific Bell's bilingual telephone services plan and require periodic reports of progress (Section VI, infra). We also adopt Pacific Bell's Female/Minority Business Enterprise budget for the test year (Section VII, infra).

We confirm the $230 million cap imposed in Phase 1 relative to San Ramon Valley construction costs (Section VIII, infra).

We adopt DRA's productivity incentive plan, with certain modifications, including a 2.9% productivity factor (vs. the 3.5% factor DRA had recommended) (Section IX, infra).

We adopt several adjustments in the settlements/separations area recommended by DRA to recognize the test year impacts of the industrywide shifts associated with the SPF to SLU transition (Sections X and XI, infra).

In the area of plant utilization, we remove the $31.4 million central office-related underutilization penalty imposed in D.83-12-025, while retaining the $13.8 million penalty for underutilization of outside plant. We decline to increase the

$13.8 million penalty, as DRA requested. We also do not adopt at present the DRA forecast mechanism or the CBCHA proposals for dealing with ready-to-serve plant (Section XII, infra).

We decline to adopt DRA's 5% royalty proposal, although we impose certain "SDO" conditions and require that their effectiveness be monitored, with a report to us, within 24 months. We retain the $4 million revenue requirement adjustment imposed in Phase 1 until the auditors complete their ongoing audit. We also adopt DRA's recommendation for a 25% employee transfer fee, a 13% referral fee, and additional adjustments associated with property transactions (Section XIII, infra).

Finally, for strictly logistical reasons, as discussed in Section XIV, we defer the modernization issue, which has no Phase 2 revenue requirement impact, to a separate decision, to be issued shortly.

Comments: ALJ's Proposed Decision

On November 18, 1987 pursuant to Rule 77.1 et seq. of the Commission's Rules of Practice and Procedure, the ALJ's Proposed Decision was filed and served on the parties. On December 8, 1987 Comments were filed by Pacific Bell, the Division of Ratepayer Advocates (DRA), TURN, Pacific Telesis Group, PacTel Companies, Southern California Gas Company, CBCHA, and Public Advocates. Reply Comments were filed by Public Advocates on December 11, 1987, and by Pacific Bell, Pacific Telesis Group, and DRA on December 14, 1987.

We have carefully considered these comments, which covered many different issues in the proceeding. We have corrected certain technical and numerical errors and references noted by Pacific Bell and DRA in connection with the SRVP and utilization issues. We have also clarified the reference to Pacific Bell's position with regard to Tariff Rule 12 at pp. 90-91 of the Proposed Decision. There are other minor typographical and editorial

revisions throughout the decision; these revisions will be obvious to those familiar with the issues addressed in the comments.

Our review of the comments has also persuaded us to modify other portions of the Proposed Decision. These modifications relate to the adopted productivity index (Section IX. E), the DRA forecast mechanism's relationship to Pacific Bell's future request for removal of the outside plant underutilization penalty (Section XII. C), the OSP consultant issue (Section XII. B), business customer itemized billing (Section V. E), and provisions outlining the details of the ratepayer education trust fund (Section V. D).

Many of the comments, especially (but not exclusively) the Reply Comments, contained extensive reargument of the parties' positions. In accordance with the Rules, we have not considered such rearguments in our deliberations.

Separate from our consideration of the comments, we have added Secton XVI, which discusses billing changes associated with today's order and provides for replacement of existing surcharges by implementing new surcharges. In order to reflect all Phase 2 adjustments in these new surcharges, we have added to this decision, a discussion (including findings and ordering paragraphs) of the intraLATA SPF to SLU and ZUM expansion issues. These additional matters would otherwise have been addressed in the forthcoming rate design decision. Parties active in the rate design phase of this proceeding should review these additions.

II. Procedural Background

A. Phase 1 of the Proceeding

Pacific Bell filed Application (A.) 85-01-034 on January 22, 1985, requesting authority to increase intrastate rates by approximately $1.4 billion, based on a 1986 test year.

On March 20, 1985 we issued Order Instituting Investigation (I.) 85-03-078, joining all local exchange telephone utilities and Pacific Bell as respondents, and consolidating the investigation with this rate case. Issuance of the investigation furthered our goal of completely reviewing the reasonableness of Pacific Bell's rates by:

1. Placing Pacific Bell fully on notice that its rates could be <u>reduced</u>, as well as <u>increased</u>.

2. Enabling us to consider fully the ramifications of potential rate changes on the other respondents, who join in a number of Pacific Bell tariffs, including those covering intraLATA toll and carrier access charges.

3. Facilitating the ordering of appropriate changes to Pacific Bell's rates, charges, or practices beyond those proposed by Pacific Bell itself.

Our review of Pacific Bell's 1986 test year operations has occurred deliberately in bifurcated fashion. Initially in the immediately preceding rate case decision ((D.) 84-06-111, as modified by D.84-09-086), we stated our intent to bifurcate the 1986 test year proceeding into a results of operations/surcharge phase (January 1, 1986 decision due date) and a rate design phase (July 1, 1986 decision due date), in order to accommodate the detailed cost studies ordered in D.84-06-111. Thereafter, in D.85-09-018 we extended the schedule of the proceeding to allow additional time for development of the record on modernization, utilization, productivity, and interest synchronization issues prior to issuance of a final Phase 2 decision (year end 1986). That schedule has been extended even further, for reasons subsequently detailed.

Fifty-four days of evidentiary hearings were held, and 233 exhibits received in evidence, during what has come to be

called Phase 1. During the course of Phase 1, Pacific Bell amended its application, reducing its $1.4 billion request in view of January 1985 represcription effects, lowered inflation estimates, a reduced requested return on equity, and other corrections. By the time hearings concluded, Pacific Bell had lowered its requested increase to $425.5 million, to recognize the revenue requirement effects of (1) D.85-08-047 (the capital recovery decision issued in this proceeding), and (2) use of more current inflation forecasts. Division of Ratepayer Advocates' (DRA's) recommendation at the conclusion of Phase 1 was a $404 million revenue requirement reduction.

On January 10, 1986 we issued D.86-01-026, the Interim Opinion in Phase 1, reducing Pacific Bell's rates by $123.8 million and adopting a 2.43% billing surcharge on most intraLATA services. Pacific Bell filed an application for rehearing of D.86-01-026, and in response, we modified the reduction to $120.6 million (2.48% billing surcharge) (D.86-03-049).

B. Phase 2 of the Proceeding

1. Initial Scope of Phase 2

We indicated that hearings would continue (Phase 2) to address a number of issues highlighted in the Interim Opinion, and previously delineated in D.85-09-018, including:

> "1. Whether to remove the $45.4 million adjustment to reduce gross revenue requirement imposed by D.83-12-025, continued by D.84-06-111 and addressed further by D.85-09-085.
>
> "2. PacBell's plant use and modernization programs (aside from the adjustment ordered by D.83-12-025).
>
> "3. The overall labor improvement productivity factor to be applied in PacBell's attrition filings for 1987 and 1988 (Resolution ALJ-156, adopted on October 17, 1985, directed PacBell to have two attrition years after test year 1986).

"4. Review of the effects of the industrywide shift of revenue from carrier access services on PacBell's settled test year revenue from carrier access services.

"5. Whether to recognize the synchronization of interest on accumulated deferred investment tax credits for purposes of computing income tax expense for ratemaking.

"6. The results of staff's completed audit of PacBell's transactions with affiliates in the Telesis Group and Staff's analysis of PacBell's San Ramon Valley complex.

"7. PacBell's endeavors to comply with our past decisions and otherwise encourage female and minority business enterprise.

"8. The full ambit of rate design issues." (D.86-01-026, mimeo. pp. 5-6.)

2. Additional Issues Considered in Phase 2

In addition to the issues so specified, we were required to review Pacific Bell's marketing practices during Phase 2, resulting in issuance of an order to show cause (D.86-05-051), a cease and desist order (D.86-05-072), and a customer notification/refund decision (D.86-08-026). Further hearings were held in Phase 2 to consider additional remedial orders as well as penalty proposals addressing Pacific Bell's violations of statute, general order, and tariffs in connection with these marketing abuses. Today's order covers these topics as well.

We also reviewed the adequacy of Pacific Bell's bilingual telephone services during Phase 2, and today's decision reviews Pacific Bell's plans in this area, and discusses the extent of our continuing oversight.

In December 1986 we issued D.86-12-099 in this docket ordering Pacific Bell to make a 1987 attrition year advice letter filing to reflect financial and operational attrition. Subsequently, by Resolution T-12007, we reduced Pacific Bell's

revenue requirement by $191 million for attrition year 1987, applying our generic attrition formula to the interim results of operations (RO) adopted in Phase 1. Pacific Bell's appeal of D.86-12-099 is pending in the California Supreme Court; however, we have held a limited rehearing (in response to Pacific Bell's appeal of Resolution T-12007) of one 1987 attrition-related issue: technical update of depreciation expense (D.87-06-022), and we expect to issue our decision on that issue imminently. Further, on the attrition front, in D.87-10-075, issued October 28, 1987, we have ordered Pacific Bell to make its 1988 attrition filing on January 30, 1988, although rates are subject to refund from January 1, 1988 to account for such filing.

In December 1986, we also addressed inside wiring maintenance (IWM) issues, consolidating our generic IWM proceeding (OII 84) with this rate case docket for the purpose of considering certain technical engineering issues and revenue requirements impacts associated with implementation of a program of detariffed IWM as of January 1, 1987. We ordered respondent utilities to establish memorandum accounts to record revenue and expenses associated with this program after January 1, 1987, and designated rates subject to refund after January 1, 1987 so that any contribution afforded by detariffed revenues can subsequently be reflected in respondents' results of operations (D.86-12-099, mimeo. p. 2). These matters are now proceeding independently from Phase 2 and are being heard before Administrative Law Judge (ALJ) Ford. One of the issues being considered is whether it is reasonable to use Pacific Bell's Adopted Results of Operations modified to reflect 1987 operational levels to determine the appropriate revenue requirement adjustments due to the deregulation and detariffing of inside wire services.

3. Comprehensive Modernization Studies Deferred

Finally, as our discussion of modernization issues, infra, indicates, we have deferred consideration of Pacific Bell's

A. D. Little Report and DRA's additional modernization report until after completion of Phase 2. In D.86-08-079 issued in response to Pacific Bell's application for rehearing of D.86-06-021 (a decision responding to DRA's Petition for Modification of the Assigned Commissioner's Procedural Schedule) we also noted that we would not consider DRA's recommended $43 million modernization-related disallowance until these additional comprehensive reports have been presented (D.86-08-079, mimeo. p. 2).

4. **The Phase 2 Record**

Phase 2 (and other related) rate design issues were heard before ALJ Colgan from July 7, 1986 through December 19, 1986. During 35 days of evidentiary hearings, ALJ Colgan heard the testimony of 57 witnesses, and received 177 exhibits into the record. Opening briefs were filed on February 9, 1987 and reply briefs were filed on February 24, 1987.

Phase 2 RO issues were heard before ALJ Colgan from December 16-20, 1985 (Female- and Minority-Owned Business Enterprises (F/MBEs) Issues), and before ALJ Carew from March 10-14, 1986 (interest synchronization), and from May 16, 1986 through February 6, 1987 (all other Phase 2 RO issues). The parties presented the testimony of 96 witnesses on RO issues; 256 exhibits were received in the record. The parties filed opening briefs on March 20, 1987, and reply briefs on April 13, 1987. We held an en banc oral argument on RO issues on July 10, 1987.

The final positions of Pacific Bell and DRA are detailed in a Joint Comparison Table (Exhibit 754). As the attached table from Exhibit 754 indicates, there is a $202.8 million difference in the positions of these parties, since DRA recommends a total reduction of $181,964,000 in Phase 2 and Pacific Bell recommends a $20,862,000 increase.

TABLE A
PACIFIC BELL

SUMMARY OF INCREMENTAL REVENUE REQUIREMENT ADJUSTMENTS TO D.86-03-049 FOR PRESENT RATES (DECEMBER 31, 1986)

REVENUE REQUIREMENT (AS OF FEBRUARY 11, 1987)*

TEST YEAR 1986 ($000)

(A) LINE NO.	(B) DESCRIPTION	(C) PSD	(D) UTILITY	(E) UTILITY EXCEEDS PSD AMOUNT
PHASE II INTRASTATE REVENUE REQUIREMENT				
1	True up of interLATA pool & interLATA SPF to SLU	28,469	756	(27,713)
2	True up of intraLATA pool	(72,540)	0	72,540
3	Acct. 645 permanent separations procedures	14,268	14,268	0
4	Direct assignment of closed end WATS	(24,418)	(24,418)	0
5	PSD's intraLATA SPF to SLU proposal	(12,078)	(12,078)	0
6	Interest Synchronization	(28,653)	0	28,653
7	San Ramon Construction	(20,705)	0	20,705
8	Settlement impact of surcharge elimination from pooling	11,545	11,545	0
9	Subtotal:	(104,112)	(9,927)	94,185
PHASE II MISCELLANEOUS REVENUE REQUIREMENT ADJUSTMENTS				
10	ZUM Expansion	(15,088)	(15,088)	0
11	Telesis Audit	(17,203)	4,000	21,203
12	Advice Letter Adjustments	(5,900)	(5,900)	0
13	Utilization	9,839	41,380	31,541
14	Penalty for abusive residence marketing activities	(49,500)	0	49,500
15	LRS Fund (ICD High Cost Fund)	0	6,397	6,397
16	Modernization **	**	**	-
17	Subtotal:	(77,852)	30,789	108,641
	Phase II Total:	(181,964)	20,862	202,826

Although this is a summation of each individual adjustment, the interaction of all the adjustments combined with each other must be considered when determining this total adjustment.

18	D.86-03-049 Adopted Results	(120,649)	(120,649)	0
19	GRAND TOTAL	(302,613)	(99,787)	202,826

Footnotes:

* This table summarizes the revenue requirement differences between PSD and Pacific as of February 11, 1987.

** Per D.86-08-079 dated August 18, 1986, the Modernization issue has been deferred until fall of 1987.

5. <u>Additional Matters</u>

This docket remains open for the following matters:

1. Further hearings on the two comprehensive modernization reports deferred from Phase 2, as well as DRA's recommended modernization related disallowance ($43 million).

2. Additional proceedings related to the IWM issues being heard before ALJ Ford.

3. Further proceedings in connection with DRA's continuing audit of affiliated transactions.

4. Final disposition of any outstanding rate design issues to be reviewed in connection with our OII on the future regulatory framework, I.87-11-033.

5. Receipt of various compliance filings ordered, infra.

We proceed now to discuss the outstanding RO issues. A separate decision resolving pending rate design matters will be issued shortly. In addition, as discussion infra in Section XIV, a separate modernization issue will be issued shortly.

III. Policy and Legal Issues

A. Introduction

The complexity of the numerous issues reviewed in Phase 2 has raised questions about the standards the Commission should employ in reaching its ultimate decision. Several Phase 2 issues were carried over from Phase 1 at specific Commission direction, with instructions to DRA to assist in developing an evidentiary record on these points. This applies to issues such as the reasonableness of San Ramon Valley expenditures; the completion of DRA's audit of the affiliated and subsidiary relationships of the Pacific Telesis family and its impact on the regulated operations of Pacific Bell; and the modernization, utilization, and

productivity issues touched upon in Phase 1. In addition, several issues were specifically added to Phase 2 by the Commission due to the press of events. Falling into this category is the marketing abuse question.

As the subsequent development of these issues will demonstrate, Phase 2 has involved a great deal more than a mere examination of Pacific Bell's rate increase request; indeed, the basic revenue requirement issues were resolved in the interim decision of January 1986. The purpose of Phase 2 was to allow additional time to more carefully and adequately review Pacific Bell's operations in connection with the 1986 test year.

As is customary in Commission proceedings of this sort, the evidentiary record was developed via presentation of evidence by Pacific Bell, DRA, and various interested parties. Serious questions arose in this proceeding, however, due to the fact that Phase 2 was essentially a large-scale reasonableness or prudence review. These issues centered around the twin concepts of burden of proof and standard of review to be applied in conducting prudence reviews. Understanding that the burden of proof issue in particular would be a matter of great controversy, the ALJ requested the parties to brief this point. We proceed now to analyze the arguments of the parties on the burden of proof issue. We will also discuss the standard of review employed, as we dispose of each Phase 2 issue where such discussion is relevant.

B. Burden of Proof

1. Pacific Bell's Position

Pacific Bell believes that the burden of proof issue is fairly straightforward. In its view, the party raising a specific issue (i.e., the moving party on the issue) has the burden both of presenting its case and also of proving its case by substantial evidence. Pacific Bell believes it is absolutely clear that the burden of proof on those issues on which DRA was the moving party generally rests with the DRA.

In support of this general proposition, Pacific Bell cites the Commission's decision in Investigation Into Operations of Davies Warehouse, Co., 66 CPUC 731 (1967), wherein the Commission held that the staff, as the moving party, had the burden of proof, and that failure to carry this burden mandated dismissal of the DRA's allegations. Pacific Bell maintains that the holding of Davies Warehouse is directly on point, since this proceeding too involves an OII and that DRA is the moving party on these issues. Pacific Bell does not accept the burden to prove that DRA's allegations are false and its proposals inappropriate; rather, it asserts DRA has burden to prove that its own allegations are true and its recommendations are appropriate.

Pacific Bell also asserts that the appropriate standard to be followed under prior Commission precedents (including Petition of Northern California Agency for Rehearing of D.81186, 75 CPUC 227, 229 (1973)), is that the moving party must carry its burden of proof by "substantial evidence."

Pacific Bell reviews a series of recent Commission decisions, including the Pacific Gas and Electric Company (PG&E) Helms decision, (D.85-08-102), wherein, in Pacific Bell's view, the parties themselves recognized that DRA had the burden to establish PG&E's imprudence, and consequently PG&E concentrated on rebutting DRA's showing. Pacific Bell argues that the Helms decision is particularly apropos in this case since DRA was afforded the "tremendous tactical advantage" of having the last word on those subjects it affirmatively raised. Thus, in both the Helms matter and in this proceeding, "the trier of fact recognized that DRA had the burden." (Pacific Bell opening brief, p. 26.)

Pacific Bell also distinguishes the October 1986 SONGS decision (D.86-10-069), wherein the Commission ruled that the applicants had the affirmative burden of establishing the reasonableness of their request. Pacific Bell maintains that the instant proceeding is entirely different. For example, DRA's

modernization report focused on capital expenditures made over a seven- or eight-year period preceding the test year being litigated. In Pacific Bell's view, this is an ex post facto review by the DRA, not a challenge to present test year estimates. The same is true with the Pacific Telesis affiliated transactions, sales marketing practices, the San Ramon Valley project, prospective utilization issues and the separation/settlements issue. Thus, in Pacific Bell's view, the SONGS decision as it relates to burden of proof, is inapplicable to the issues now before the Commission.

2. DRA's Position (Opening Brief)

DRA begins its discussion of burden of proof by outlining general principles which distinguish between the burden of proof and the burden of going forward. These are twin concepts which are occasionally confused. According to DRA, the ultimate burden of proof never shifts. The party having the burden of proof has the initial burden of going forward and presenting proof of the facts necessary to compel a decision in its favor. The burden of going forward, or of producing evidence, will shift to other parties when the party with the initial burden has presented evidence of sufficient weight that a determination in its favor would be required in the absence of contradictory evidence. Basically, whatever facts a party must plead to state its case, it also has the burden of proving. Stated another way, the burden of proof follows the burden of pleading (1 Witken California Evidence 3d, 113-117.).

DRA argues that the current burden of proof controversy must be viewed in the context of Pacific Bell's status as a regulated utility. It is well settled regulatory law that a utility seeking an increase in rates has the burden of showing by clear and convincing evidence that it is entitled to such increase. Any doubts must be resolved against the party upon whom rests the burden of proof. If the utility does not sustain the burden of

satisfying the Commission that the proposed increase is justified, the application will be denied. (Pacific Telephone and Telegraph Company, D.90642, A.58233 (1979), 2 CPUC 2nd 89 at 98.)

In DRA's view, the Commission may choose its own criteria or method of arriving at a decision based upon the record before it. It may make pragmatic adjustments to protect the ratepayer from unreasonable costs or the imprudent actions of utility management. The ultimate burden of proof as to the reasonableness of the utility's actions rests upon the utility. Under established Commission precedents, this is the applicable rule:

> "A fundamental principal involving public utilities and their regulation by governmental authority is that the burden rests heavily upon a utility to prove that it is entitled to rate relief and not upon the Commission, the Commission staff, or any interested party, or protestant to prove the contrary." (Southern Counties Gas Co. 58 CPUC 27 (1960); Southern Cal. Gas Co. 58 CPUC 57 (1960); Suburban Water Co. 60 CPUC 183 (1962).)

According to DRA, a necessary corollary to this allocation of the burden of proof is that a party proposing some different result than that sought by the utility has the burden of (a) going forward in producing evidence which raises a reasonable doubt as to the utility's position (citing Evidence Code § 115) and (b) presenting evidence explaining its own position. (Environmental Defense Fund Inc., v. EPA, 548 F. 2d 988) (D.C. Cir. 1976) at 1004; and Supplemental Opinion on Petition for Rehearing, 548 F, 2d 1012 et seq., cert. den. 431 US 925 (1977)) hereinafter the EDF decision.

Given the fact that this proceeding began with the filing of a general rate increase application by Pacific Bell, and proceeded to issuance of an interim order (D.86-01-026) establishing a test year 1986 revenue requirement and setting rates subject to refund in view of further possible reduction in this

Phase 2, DRA accepts the notion that it had the obligation of going forward on those issues which it advanced. These issues include modernization, productivity, the San Ramon Valley project, the Telesis Audit, Marketing Abuse, and Prospective Aspects of the Utilization issue. As the party with the obligation going forward, DRA agrees that it must produce evidence which supports and explains its position and tends to raise a reasonable doubt concerning Pacific Bell's position. DRA also believes it has the right to close on those issues, which is particularly appropriate in the instance where most of the factual information relied upon by DRA was obtained from Pacific Bell. It is Pacific Bell who controls the release of such information in response to staff data requests and in cross-examination of company witnesses. It is Pacific Bell through control of its operations that has the most knowledge of such operations. Accordingly, in DRA's view, it is "abundantly appropriate" for DRA to close on issues on which it has the burden of going forward. Otherwise, by not being fully responsive to discovery requests, Pacific Bell would have the opportunity to produce new information and raise new issues to which DRA would not have the opportunity to respond. This procedure, which DRA believes is consistent with the ALJ's February 11, 1987 written ruling and the ruling from the Bench of November 12, 1986 (TR. 16719), also appropriately places upon Pacific Bell the ultimate burden of proving the reasonableness of its actions through full and timely responses to staff data requests.

Thus, while staff asserts and accepts the obligation of going forward on certain issues, it maintains that this fact does not shift the ultimate burden from the utility of proving the reasonableness of its actions. The latter notion is premised on the fact that Pacific Bell is in control of its operations and possesses all the information necessary to justify its rate request

and the underlying reasonableness of that request. No other party has access to this information on the same basis.

3. Pacific Bell's Position (Reply Brief)

Pacific Bell strongly criticizes DRA's burden of proof analysis, arguing that it cites principles applicable to civil law proceedings without indicating how those principles or statutes apply to the unique procedural settings of Phase 2, an administrative law proceeding. Similarly, Pacific Bell criticizes DRA's reliance on the EDF decision, which dealt exclusively with Federal law, specifically the highly specialized Federal Insecticide, Fungicide and Rodenticide Act (FIFRA). FIFRA had been amended in 1964 specifically to shift the ultimate burden of persuasion in cancellation proceedings from government to manufacturer; moreover, the Court of Appeals ruled that FIFRA's allocation of the burden of proof was in accordance with an express EPA statute (40 C.F.R. 164.121(g)) which governed the burden of proof in suspension proceedings, and specifically placed that ultimate burden on the manufacturer. Pacific Bell argues that no similar statute applies to Phase 2. Additionally, the EDF decision relied heavily upon the fact that FIFRA suspension proceedings relate to situations which could irreparably imperil the public health and safety. Pacific Bell notes that no such instance applies here.

Pacific Bell believes that DRA has provided no support for its contention that the utility always has the ultimate burden of proof, no matter what the issue or procedural situation, on the rationale that nearly all cases involve situations where factual information must be obtained from the utility. According to Pacific Bell, DRA's argument must be rejected for what it is: A request for a ruling that DRA never has to prove anything. Such a burden of proof allocation would amount to a "presumption of unreasonableness" or an "imprudent until proven prudent" standard

of review of utility actions. Such an allocation should be rejected as unsound regulation.

In conclusion, Pacific Bell argues that DRA was allowed to proceed first and to close on nearly every issue in this final phase of the case, thus acquiring the procedural advantages reserved to party shouldering the ultimate burden of proof. Pacific Bell argues that placing the burden after the fact on the utility, after having repeatedly denied the normal procedural advantages afforded a party responding to another's allegations, would constitute a fundamental denial of procedural due process. Such an outcome would be all the more untenable given the hundreds of millions of dollars of recommended penalties and disallowances at stake.

4. Pacific Telesis Group's Reply Brief On the Burden of Proof Issue

Pacific Telesis Group (PTG) addressed the burden of proof issue in its reply brief. PTG maintains that DRA has the burden of proof on affiliated transaction issues, because it seeks affirmative relief, i.e., a 5% royalty, a 13% referral payment, a 25% employee transfer payment, and many new rules and regulations. As the proponent of these changes in the status quo, DRA bears the burden of proof. For the latter proposition, PTG cites Evidence Code § 500 which provides that "[A] party has the burden of proof as to each fact the existence or nonexistence of which is essential to the claim for relief or defense that he is asserting."

PTG cites two California Supreme Court decisions discussing burden of proof in the context of Commission decisions. In both cases the proponent of change was said to have the burden of proof (County of Inyo v P.U.C. 26 Cal 3d 154, 159, note 4 (1980)) (See also Goldin v P.U.C., 23 Cal 3d 638, 665, (1979)).

PTG's brief also cites several Commission decisions, including Re Union Pacific RR Co., 6 Cal P.U.C. 2d 196, 200 (1981); Re Stanley et al., 4 Cal P.U.C. 2d 37 at 44 (1980); William H.

Hutchinson & Sons, Inc., 73 Cal P.U.C. 771, 783 (1972). These cases assert that the staff has the burden of proof when it seeks to enforce laws, general orders, or tariffs.

PTG argues that the EDF decision is not relevant to the facts at hand, basing its critique of staff's reliance on this case on the same arguments proffered by Pacific Bell in its reply brief.

PTG believes that a more recent case on burden of proof issues under Federal Law is of interest; in that case the DC Circuit held that the EPA had not satisfied its initial burden:

> "[A]n initial burden of promulgating and explaining a non-arbitrary, non-capricious rule rests with the Agency and we think that by failing to explain how the standard proposed is achievable under the range of relevant conditions..., the Agency has not satisfied this initial burden." (National Lime Assn v EPA, 627 F. 2d 416, 433 (1980).)

PTG submits that DRA too has not explained its proposed new rules nor shown them to be non-capricious and nonarbitrary. Even if the DRA had only an initial burden of going forward, PTG believes that DRA has failed to meet even that burden, let alone the full burden of proving that its proposals are needed.

5. **DRA's Reply Brief Position**

DRA notes that this is the first general rate case by Pacific Bell since divestiture. Initially, Pacific Bell requested a rate increase in excess of $1 billion (this amount was subsequently reduced). The ultimate burden of proof is on Pacific Bell to justify this rate increase and further to justify that its actions in the conduct of its operations are reasonable. Pacific Bell must establish the need for this increase and the reasonableness of its operations through clear and convincing evidence.

DRA stresses that the regulated utility is permeated with a public interest, with all of its actions subject to regulatory scrutiny. In the case of the Commission, that scrutiny is premised

on authority derived from the California Constitution (Article 12, Section 6), as well as relevant statutes setting forth the powers and authority of the Commission (Public Utilities (PU) Code § 314) and the obligations of public utilities under regulation (PU Code §§ 581, 582). DRA, the assigned staff in this proceeding, is the investigation branch of the Commission in fulfilling the foregoing responsibilities and carrying on the day-to-day tasks inherent in these responsibilities.

DRA's ultimate position is that Pacific Bell has not met its burden of proof in the areas challenged by staff. In the areas where the Commission in D.86-01-026 held the record open for further development by DRA in response to the initial application of the utility, DRA had the burden of going forward. It submits it has met that burden.

DRA also argues that the Commission authorities relied upon by Pacific Bell are not appropriate and do not support its arguments. Specifically, DRA challenges Pacific Bell's reliance on the Davies Warehouse case, supra. DRA states:

> "In Davies as in any transportation enforcement proceeding, ..., it is the Commission through its Staff which has a statutory duty of enforcing the Public Utilities Code and the Commission rules prohibiting undercharges. In that highly specialized setting it was the Staff which investigated the books and records of carriers and where it appeared that tariffed rates were being circumvented the Staff would make a recommendation to the Commission to proceed against a carrier. In that situation a careful investigation had already been conducted by the staff and reviewed by staff counsel to determine if prima facie case existed against a carrier. If such a determination were made a recommendation was made to the Commission to proceed against the carrier in a formal proceeding. . . .
>
> "In the Davies case, the Staff asserted that the carrier had engaged in undercharges through the device of paying kick backs to a shipper by paying for alleged services provided to it but

> not actually utilized by the carrier. The Commission, upon review of the record concluded that while in some instances the carrier had paid for certain services not utilized those particular instances occurred when the carrier's driver chose not to make use of the service that was available. The Commission concluded these instances were insufficient to support the staff contention and found for the carrier.
>
> "The Davies case is far different from a rate case proceeding where the Commission has held consistently that the ultimate burden of proof of the reasonableness of its actions is upon the utility. Pacific Telephone & Telegraph Co. D.90642 2 C.P.U.C. 2d 89 at 98 (1979). It is the utility that comes forward seeking to prove the need for an increase. In so doing it exposes all of its operations to review. The reason for issuing an OII and consolidating it with such a rate application proceeding is to include all connecting telephone utilities who will be affected by any changes in Pacific Bell's rates through the separations process. The OII in such a proceeding also makes it clear that all of the utility operations and practices are open to scrutiny. In no way does such an OII relieve the utility of the ultimate burden of proving the reasonableness of its actions. Pacific Bell's reliance upon Davies is misplaced and its arguments based upon the Davies case should be disregarded." (DRA Reply Brief, pp. 5 to 6).

DRA also criticizes Pacific Bell's reliance on the NCPA case, where the Commission allocated the burden of proof on the protestant, the Northern California Power Agency. DRA says that that case represented a unique set of circumstances, since the proceeding itself was essentially a complaint proceeding, far different from a general rate case. Moreover, the burden of proof is on the petitioner for rehearing, which was the situation in the NCPA proceeding.

DRA also believes that Pacific Bell's reliance on the Helms decision is misplaced, because that situation involved a

unique circumstance where the Commission had inadvertently acquiesced in a reversal of the burden of proof, with PG&E essentially relying upon a presumption of prudence while the staff believed it was the party obligated to bear the greatest burdens with respect to reasonableness. The Commission observed in that decision that the staff was overwhelmed by the task of attempting the affirmative burden to establish PG&E's imprudence. The result was a consultant's report which did not focus upon key events or managerial decisions related to specific construction activities but focused on managerial aspects. The result was to free the utility from the affirmative burden of proving prudence. The Commission concluded in the Helms proceeding that in retrospect by issuing an OII and then permitting its staff to suffer the greatest evidentiary burdens, it had unintentionally handicapped its own review of the reasonableness of Helms capital expenditures (D.85-08-102, mimeo. p. 20).

Finally, DRA believes that Pacific Bell's reliance upon the recent SONGS decision (D.86-10-069) is equally misplaced. In that proceeding the applicant initially argued that there was a presumption of reasonableness of project expenditures and that the applicants would simply present rebuttal to DRA and any intervenor. The Commission rejected that argument, instead reaffirming the traditional requirement that applicants must justify the reasonableness of their expenditures in their direct case (D.85-06-112 at p. 4). D.86-10-069, issued October 29, 1986, in the SONGS proceeding, further discussed the allocation of burden of proof upon the applicant.

In DRA's view, Pacific Bell attempts to distinguish the traditional allocation of the burden of proof by asserting that the issues designated by the Commission in D.86-01-026 for review in Phase 2 are not a challenge to test your estimates and therefore not subject to the traditional allocation of the burden of proof. DRA strongly disagrees with this premise.

6. Discussion

On review of the extensive argument presented on the burden of proof question, we conclude that DRA has presented the most cogent analysis on the issue. Further, DRA's analysis is fully consistent with Commission authorities discussing burden of proof in the context of general rate case proceedings and prior prudence revenues. Thus, we are not swayed by Pacific Bell's argument that Phase 2 is a somewhat different procedural "animal," not involving a challenge to its test year estimates but rather an extensive review of prior years' management decisions in several discrete areas. The inescapable fact is that the ultimate burden of proof of reasonableness, whether it be in the context of test-year estimates, prudence reviews outside a particular test year, or the like, never shifts from the utility which is seeking to pass its costs of operations onto ratepayers on the basis of the reasonableness of those costs.[1] Whenever the utility comes before this Commission seeking affirmative rate relief, it fully exposes its operations to our scrutiny and review. It must justify the reasonableness of its request and its operations by making at least a prima facie case of reasonableness, even in the absence of opposition. Where it faces opposition, its reasonableness showing is naturally a more difficult undertaking.

This is a statutory obligation imposed on every public utility subject to PU Code § 451, which provides in relevant part that:

> "All charges demanded or received by any public utility...shall be just and reasonable..."

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1 The longstanding and proper rule is set forth in D.90642 at 2 CPUC 89, 98-99 and requires that the utility meet its burden by clear and convincing evidence. To meet this burden we have specified that "...the applicant must produce evidence having the greatest probative force."

PU Code § 454 further provides that:

> "...no public utility shall raise any rate or so alter any classification, contract, practice, or rule as to result in any increase in any rate, <u>except upon a showing before the Commission</u> and a finding by the Commission that the increase is justified..." (Emphasis added.)

The Commission must also be satisfied that Pacific Bell's rates, rate classifications, rules and practices, or contracts affecting rates and rate classification are just, lawful, sufficient, reasonable, and nondiscriminatory (PU Code § 728). This is obviously the key to understanding why we refused to end this proceeding at the conclusion of Phase 1. We wanted the evidentiary record developed further in connection with several matters previously described to assure that Pacific Bell's rates were reasonable. To achieve that goal, it was absolutely necessary to direct DRA to continue investigating Pacific Bell's operations and to present its findings in Phase 2. In so doing, we did not transfer the ultimate burden of proof of reasonableness from Pacific Bell to DRA.

In the situations we are reviewing in Phase 2, both DRA and other parties have challenged the reasonableness of certain utility operations. Thus, there is a counterpoint which we can use in these instances to test Pacific Bell's position. We agree with DRA's assessment that where other parties propose a result different from that asserted by the utility, they have the burden of going forward to produce evidence, distinct from the ultimate burden of proof. The burden of going forward to produce evidence relates to raising a reasonable doubt as to the utility's position and presenting evidence explaining the counterpoint position. Where this counterpoint causes the Commission to entertain a reasonable doubt regarding the utility's position, and the utility

does not overcome this doubt, the utility has not met its ultimate burden of proof.

To understand this basic point, it is obviously necessary not to confuse disallowances for unreasonableness with "penalties." Pacific Bell has used the word "penalty" several times in its discussion of the burden of proof issue. The use of this term interchangeably with the concept of disallowances for unreasonableness confuses the burden of proof issue. In most cases involving DRA recommended penalties, such as the OIIs cited in PTG's reply brief[2] or the Davies Warehouse case cited by Pacific Bell and discussed by DRA in its reply brief, where DRA is affirmatively seeking a statutory or other penalty based in a violation of statute, rule, order, or tariff, it indeed does have the burden of proving that there has been such a violation, or some other conduct by the regulated entity which justifies imposition of a penalty. In this limited situation we are prepared to acknowledge that the ultimate burden of proof that such violation has occurred rests with the party initiating the investigatory action. Similarly, in Phase 2, where DRA and other parties are

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2 PTG's reliance on two California Supreme Court cases is misplaced. County of Inyo v PUC, (1980) 26 Cal 3d 154, 159 note 4 involved an underlying complaint proceeding, where complainants were alleging existence of discriminatory rates. In such a quasi judicial proceeding, the Commission imposes the burden of proof on the complainants, not the defendant utility. However, it does impose the burden of proof of reasonableness in a quasi legislative ratemaking proceeding on the utility. PTG also cites Goldin v PUC (1979) 23 Cal 3d 638, 665 involving a Commission rule (known as Rule 31) which created a forum for customers whose service had been disconnected (by the utility at the instance of a law enforcement agency (based on probable cause re a violation of law)) to secure restoration of service. The rule specifically imposed the burden of proof (re violation of law in connection with the customer's use of utility service) on the law enforcement agency choosing to participate in such proceeding. This situation is obviously distinguishable from the Phase 2 reasonableness issues.

recommending penalties due to Pacific Bell's violation of statues, general orders, and tariff in connection with the marketing abuse problem, we are prepared to say that these parties have the ultimate burden of proof regarding existence of the violation and the appropriate penalty to be imposed.

A disallowance, on the other hand, is imposed by this Commission on the recommendation of DRA or other interested parties based on a finding that the utility has acted imprudently or unreasonably. Such a disallowance is keyed to the failure of the utility to meet its ultimate burden of proof, either initially or by failing to overcome reasonable doubts raised by other parties' showings. In that situation we are satisfied that DRA has correctly characterized the burden by distinguishing between the twin concepts of ultimate burden of proof and burden of producing evidence.

Given that circumstance, it was entirely appropriate to allow DRA to open and close in the presentation of evidence on those issues where DRA was the moving party in terms of the burden of going forward to produce evidence. We agree with the DRA's analysis that any other treatment runs the risk that information will be held back and presented at a time when it is too late for the moving party to address it. Pacific Bell's procedural due process arguments are not persuasive, given its ultimate control over the information which forms the basis of any reasonableness finding, and given the fact that it was provided every opportunity to present rebuttal testimony on each key point.

C. Standard of Review

One of the policy issues which Pacific Bell has emphasized is the appropriate standard of review to be followed by the Commission in conducting a prudence review, especially in connection with the Phase 2 issues of modernization and the San Ramon Valley Project. Pacific Bell identifies these projects as after-the-fact evaluations of capital budgeting decisions where the

application of a prudence standard is required. Pacific Bell presented the direct testimony of Dr. Lewis Perl, who described some principles for reviewing the prudence of capital investment decisions. Dr. Perl admitted that analysts who have evaluated utility prudence issues have differing views, but that there are certain broad principles upon which most analysts agree. Pacific Bell believes that DRA and its modernization consultants concur with most of these principles, but states that there is some controversy over whether DRA has properly applied them in its review. Pacific Bell's critique of DRA is set forth in more detail in our discussion of the modernization issue. For purposes of simply setting forth the principles in introductory fashion, a brief description of the seven principles follows:

The first principle is that an evaluation of past decisions can only be based upon the information and techniques available at the time the decision was made. Subsequent changes in circumstance which reasonably could not been anticipated should not be considered in evaluating the prudence of these decisions. In response, DRA stresses that the information must be available to a reasonable decision-maker; it also asserts that decisions not immediately implemented must be restudied/reviewed prior to implementation (DRA reply brief, pp. 135-138).

The second principle is that an evaluation of the past decision must distinguish between the underlying prudence of the decision and the correctness of that decision. In other words, the underlying question is whether the decisionmaker was making a reasonable assessment of the future, not whether future events occurred exactly as predicted. In response, DRA argues that errors in data base, etc., imply managerial process imprudence. Also a decision may happen to be correct, but be based on flawed data/procedures which are implicitly imprudent (DRA reply brief, pp. 138-140).

The third principle is that an incorrect or imprudent decision should result in disallowance only when, and only to the extent that, the decision results in demonstrably adverse consequences to consumers. In any decision-making process, there are bound to be some errors. Management cannot seek to develop a perfect investment decision-making process, but should seek to develop processes which invest reasonable amounts of time and effort in making reasonable decisions and expending reasonable efforts in managing those investments once those decisions are made. Therefore, if imprudence is in fact discovered, the penalty should only be in proportion to the harm done. This general principle is sometimes referred to as the "no harm, no fault" principle. DRA counters that discrete decisions should be separately evaluated and not aggregated, creating possible masking effects. Also actual economic losses are not the trigger for an imprudence finding. Finally, when optimum economic benefits are not achieved for ratepayers, they are paying more than they should be paying (DRA reply brief, p. 141).

The fourth principle is that a large corporation's management processes should be evaluated based upon overall effectiveness. This is due to the fact that large corporations' investment decisions are rarely centralized at a single point; typically, there are critical decision-making points, such as the establishment of broad guidelines for decisions, the implementation of specific investments which are consistent with these guidelines; and the management of specific investments after decisions to undertake them have been made. The critical question to be evaluated is whether the process as a whole works well, not whether specific components appear flawed when viewed in isolation. DRA counters that numerous wrong decisions are not permissible if the overall effect is marginally beneficial, since ratepayers are entitled to optimum benefits. Utility managers are obligated to

provide the best available information and tools (DRA reply brief, p. 143).

A fifth principle is that if sampling is used to evaluate an investment process, they must be large enough and selected representatively so as to reliably represent the investment process as a whole. This principle goes to the rigor of the Commission's review of the utility action and how high a standard to apply in that review. Pacific Bell argues that the standard must be reasonably attainable by a reasonable manager who is in fact a human being. In short, the standard must be fair. DRA responds that in conducting an overall evaluation for process review purposes, correction/improvement need not incorporate statistically valid large samples (DRA reply brief, p. 143).

A sixth principle is that any realistic evaluation of the prudence of an investment decision should take into account an assigned value for all of the measurable outcomes of the investment. This principle holds that the best investment is not necessarily the one associated with the lowest cost, but rather that which provides the greatest excess of value over cost. DRA counters that all forecasted measurable outcomes do not have the same degree of certainty (DRA reply brief, pp. 144-145).

Finally, the seventh principle is that evaluations must consider the constraints under which the decision was made. For example, in evaluating the prudence of equipment utilization, Pacific Bell asserts that the constraints imposed by the obligation to serve must be taken into account. DRA responds: "Crying about competition and the obligation to serve should not be allowed as an excuse for building excess plant." (DRA reply brief, p. 145.)

In Pacific Bell's view the above seven principles form a "bedrock" upon which the ultimate decision should be made concerning the prudence of Pacific Bell's capital investment decisions.

DRA submits that the standard of review proposed by Pacific Bell is not applicable, since there are numerous Commission decisions setting the appropriate standard of review in proceedings comparable to Phase 2. In DRA's view, not only does Pacific Bell have the ultimate burden of proof of the reasonableness of its actions, but it must also carry that burden by clear and convincing evidence. The staff as the moving party on the issues designated by the Commission for further record development in Phase 2 has the burden of going forward. The staff must present testimony and evidence that explains its position and raises a reasonable doubt with respect to the company's position where the staff differs from the company. (This does not shift the ultimate burden from the utility to prove reasonableness on a clear and convincing basis.) Where reasonable doubts have been raised by the staff or any other moving party as to the reasonableness of the company's actions, the Commission can adopt the opposing recommendations or make other findings based upon its review of the record.

We find Pacific Bell's guidelines a helpful framework for testing the prudence question, but we do not wish to be bound by a precise formula for gauging reasonableness. Obviously our assessment in each proceeding will depend upon the facts as they are developed in the evidentiary records before us. Clearly it is difficult to disagree with the guidelines Pacific Bell has submitted, since on their face they seem eminently sensible. But DRA's responsive caveats highlight the danger of oversimplifying our review by relying simply on the bare guidelines. We prefer the course of action that we have traditionally adhered to, which involves case-by-case analysis of the prudence question, and individualized and particularized review of the evidentiary record before us. It will be clear as Pacific Bell and the other parties review our disposition of the issues in Phase 2 that on each and every issue we have considered the reasonableness of the utility's actions, as well as the challenges to the utility's showing, and

have arrived at our result based upon our assessment of reasonableness grounded in the evidentiary record.

IV. Interest Synchronization

A. Procedural Background of the Interest Synchronization Controversy

As noted earlier the interest synchronization issue was heard and submitted for decision-making purposes earlier than the other issues considered in Phase 2. For this reason we take it up first.

Initially the issue of interest synchronization was raised during Phase 1 of this proceeding by Toward Utility Rate Normalization (TURN), which sought an extension of the applicable testimony due dates in order to address the issue; TURN's request was initially rejected by then assigned ALJ Alderson. Shortly thereafter, on June 26, 1985, the Internal Revenue Service (IRS) issued IRS Announcement 85-96 and "Proposed Regulations on 'Interest Synchronization' as it affects Investment Tax Credits for Public Utilities, filed June 20, 1985" (The IRS Proposed Regulations), in which it indicated that interest synchronization is acceptable under the Internal Revenue Code (IRC). In the wake of these developments, TURN renewed its efforts to inject the interest synchronization issue into Phase 1 of the rate case by filing a motion, identifying the magnitude of the dollars at stake. Pacific Bell opposed TURN's motion, although the motion was supported by the Center for Public Interest Law (CPIL).

On July 29, 1985, ALJ Alderson issued a formal ruling allowing TURN to file interest synchronization testimony on December 16, 1985, and directing Pacific Bell and DRA to file on the same date. The ruling was affirmed by the Commission in D.85-09-018.

In the interim opinion, D.86-01-026, the Commission indicated the interest synchronization issue would be addressed

during Phase 2 (mimeo. p. 6). In addition, the interim opinion, and the subsequent opinion modifying the interim opinion (D.86-03-049) provided Pacific Bell's intrastate rates and charges would be collected subject to refund back to March 5, 1986 in view of the further reductions in revenue requirements which could result from consideration of the Phase 2 issues, including interest synchronization.

On February 28, 1986, Pacific Bell filed a motion to defer hearings on the interest synchronization issue, scheduled to be heard March 10-15, 1986 in Phase 2. Pacific Bell urged the Commission to address this issue in the context of its proposed OII on the interest synchronization issue. Pacific Bell's motion was opposed formally by TURN on March 5, 1986. ALJ Carew denied Pacific Bell's motion on March 10, 1986, and hearings proceeded (TR. 7411-7412).

During these hearings, TURN presented the testimony of Carol T. Coffey; DRA presented the testimony of Gilbert Infante; Pacific Bell presented the testimony of Richard Walker, a Certified Public Accountant formerly with Arthur Anderson & Co. and J. R. Best, employed by PTG as Tax Manager, corporate tax department. TURN, DRA, the City of San Diego and the City and County of San Francisco (Cities), and Pacific Bell filed opening briefs on April 11, 1986. TURN, DRA, and Pacific Bell filed concurrent reply briefs on April 25, 1986, and the matter was thereafter submitted for decision-making purposes.

B. <u>What is Interest Synchronization</u>?

The issue before us is whether interest should be imputed on the portion of Pacific Bell's plant financed by investment tax credits when determining the Federal income tax allowance for ratemaking purposes. The concept of interest synchronization requires a bit more elaboration.

As TURN's witness Coffey notes, a fundamental precept of public utility regulation is that investors supply the funds to

build utility plant (i.e. rate base) upon which they are allowed to earn a return. The utility is allowed no return on portions of its plant financed through other sources (for example, accumulated deferred income taxes, contributions, advances for construction) or on plant, the cost of which has already been recovered through depreciation charges. The only exception to this basic regulatory principle is that under certain circumstances, due to mandatory provisions of the Internal Revenue Code (IRC), plant financed by accumulated deferred investment tax credits is allowed in rate base. The practical effect of this IRC provision is twofold: investors earn a return on money not provided by them, and the utility loses the income tax deduction for the interest expense that otherwise would be available if the entire plant had been financed through conventional means, including debt and equity, without investment tax credits.

It was the intent of Congress in adopting investment tax credit (ITC) provisions governing utilities, to enable the benefits of ITC to be equitably shared between investors and ratepayers. Interest synchronization is intended to achieve this sharing, by recapturing for customers that portion of the interest deduction that otherwise would have been available when computing a regulatory income tax expense allowance <u>if all of the plant (rate base) had been financed with debt and equity, i.e., without investment tax credits</u>. With interest synchronization, the portion of the utility's plant financed through ITC is assumed to have been financed with a combination of debt and equity in the same ratios and with the same imbedded debt cost as the remainder of the plant. A theoretical interest deduction is imputed on the debt portion of the ITC. An example of Interest Synchronization follows:

Let it be assumed that:

a. A utility has net plant of $125 million financed by $40 million debt at 10% interest, $40 million equity, $25 million accumulated deferred income taxes and $20

million accumulated deferred investment tax credits.

b. The utility made an Option 2 election for investment tax credit, i.e., for ratemaking purposes investment tax credit is <u>not</u> deducted from ratebase.

Ratebase Calculation	($ in millions)
Net Plant	$125
Less: Accumulated deferred income taxes	(25)
Ratebase	$100
Ratebase financed by	
Debt at 10%	$ 40
Equity	40
Accumulated deferred investment tax credit	20
Ratebase	$100

If a commission does <u>not</u> apply interest synchronization, a utility would deduct $4 million interest in calculating income taxes. ($40 million debt x 10% = $4 million.)

If a commission <u>does</u> apply interest synchronization in calculating a ratemaking income tax expense allowance, it assumes that $20 million of ratebase was financed by investment tax credit in the 50/50 ratio of debt to equity, i.e., $10 million of debt and $10 million of equity. It then would impute a theoretical interest cost of $1 million to the debt portion of the investment tax credit. ($10 million x 10% = $1 million).

This additional $1 million of theoretical interest would be used when computing a regulatory allowance for income tax expense, producing a total interest deduction for calculating income taxes of $5 million under interest synchronization.

From this example, it is clear that a larger income tax interest expense deduction will occur when interest synchronization is used. The larger interest expense deduction will result in a lower Federal income tax expense allowance for ratemaking purposes and a lower gross revenue requirement.

C. Arguments For and Against Adoption Of Interest Synchronization

1. The Debate Pro and Con

The issue of interest synchronization has been hotly debated, especially given the large amounts of money at stake. According to testimony presented by TURN in this proceeding, in 1984 the electric utilities had accumulated more than $14 billion in investment tax credits on their books; no comparable figure is available for the telephone utilities. But these figures indicate that the stakes are high.

On the consumer side if interest is imputed to a portion of investment tax credits, millions of dollars of additional regulatory interest deductions are created, thus lowering a utility's regulatory income tax expense allowance, its revenue requirement, and consequently, rates for service. On the utility side, it is has been argued that a deduction for hypothetical interest could lead to the loss of the credit itself under the Tax Code, which would result in the loss of millions of dollars of cost-free capital that otherwise would be available for investment in plant and equipment. However, since the submission of this record, this concern has been greatly minimized if not totally eliminated, by the passage of final Treasury Department regulations which were only at the proposed stage during the time this record was heard. Nonetheless, as the subsequent development of the parties' arguments will demonstrate, there is still a residual argument that the Treasury Department regulations on interest synchronization are violative of congressional intent, and subject

to legal challenge on that basis. This argument is discussed in more detail subsequently.

2. TURN's Position

It is TURN's position that the only significant argument against adoption of interest synchronization advanced at the time this record was submitted was that such adoption might result in a loss of a utility's investment tax credit if the IRS concluded that interest synchronization violated provisions of the IRC. TURN believed, however, that this remote possibility had been further reduced by IRS promulgation of proposed amendments to clarify that interest synchronization is permitted, subject to certain limitations under the ratable flow-through method of accounting. As noted earlier, Internal Revenue Service Announcement 85-96, which proposed changes in the regulatory treatment of interest synchronization, was printed on June 21, 1985 in the Federal Register. The IRS explained the reason for the proposed changes as follows:

> "Although synchronization of interest reduces cost of service, the Service has concluded that this reduction is not attributable to the credit. This conclusion is consistent with financial market realities, since, in the absence of the credit, the additional capital needed to finance the investment property generally would be obtained from a similar proportion of debt and equity as in the existing capital structure of the utility. Sychronization of interest properly takes account of the additional interest expense that would have been incurred in those circumstances.
>
> "Further, the Service believes that synchronization of interest under § 46(f)(2) results in an appropriate accounting for the credit in establishing rates. The basis for this conclusion may be illustrated by a comparison of the rates that would be established without synchronization of interest with rates that would be established if the credit were unavailable. Under certain factual

> circumstances (e.g., long lived assets with respect to which the credit was allowed), the rates that would be established without synchronization of interest may actually exceed in one or more service years rates that would be established if the credit were unavailable. In contrast, the rates that would be established with synchronization of interest cannot exceed in any year the rates that would be established if the credit were unavailable. Accordingly, proposed amendments would clarify that interest synchronization is permitted under a ratable flow-through method of accounting.
>
> "More generally, the amendments would provide that the extent to which cost of service or rate base is reduced by reason of the credit is determined by reference to the capital that would have been provided by common and preferred shareholders and long-term creditors if the credit were unavailable. Thus, a reduction in Federal income tax expense to reflect the additional interest the taxpayer would pay or accrue if the credit were unavailable is not treated as a reduction in cost of service by reason of the credit for purposes of § 46(f)(2). . . ." (IRS Announcement 85-96.)

In view of the proposed regulations, TURN argued that California should employ the strategy of adopting interest synchronization by permitting the utility to collect the full tax allowance subject to refund, pending on an ultimate resolution of the issue with the IRS. (As we have noted, that issue is now less critical due to the promulgation of final Treasury regulations).

Further, TURN argued that any adjustment adopted by the Commission should be calculated during the decision-making process based on the adopted test-year capitalization ratios, cost of long-term debt and average accumulated deferred investment tax credits.

In further arguments presented in its briefs, TURN focused on the sharing issue, arguing that interest synchronization shares ITC benefits more fairly between the utility and its

ratepayers. There is a dispute between TURN and Pacific Bell on this sharing question, which is rooted in a dispute over whether interest synchronization, as reflected in the now final Treasury Department regulations, properly carries out congressional intent on the sharing question. As discussed previously, Congress provided in 1971 that the benefits that utilities derived from ITC should be shared equitably between the utilities' ratepayers and shareholders (see e.g., Exhibit 502 at p. 3, Exhibit 503 at p. 15). The present sharing was developed by the IRS in regulations promulgated in 1979. The congressional committee reports had stated that any rate treatment was to assume that ITC replaced equity that would otherwise have been invested by shareholders. Despite this clear admonition, the 1979 regulations provide for the imputation not of the cost of common equity but the overall cost of capital, averaging the costs of common, preferred, and debt. Pacific Bell's position, with which TURN disagrees, is that there is a serious ambiguity created by the definite congressional admonition that these funds should be treated as though derived from common shareholders and the corresponding congressional directive that there be some division of the benefits or sharing. TURN believes that the IRS used its discretion to assign primary weight to the congressional policy directive to share the benefits, necessarily subordinating the apparently conflicting directive to apply the cost of common equity. The present sharing gives the shareholders access to huge sums of zero cost capital--$1.1 billion for Pacific Bell, according to witness Best (Exhibit 504 at p. 18). The annual value to Pacific Bell (given the effect of 10% ITC on the utility's $2 billion annual investment) is $200 million per year in zero-cost capital.

As a result of the new sharing suggested by proponents of interest synchronization, Pacific Bell will retain access to $1.1 billion in zero cost capital. TURN calculates, assuming Pacific Bell's $200 million ITC is split presently $190/$10 million with

the ratepayers,[3] that with interest synchronization, the split moves to roughly $185 million/$15 million, (if we assume that $100 million of ITC is treated as debt, upon which $10 million of interest (at 10%) would have been paid) creating an imputed interest deduction worth $5 million. According to TURN, the lion's share remains with Pacific Bell. Using actual numbers produced in the hearings, TURN calculates that ratepayers' test year benefits will increase by roughly 25%, and thus, application of interest synchronization will make only marginal changes in the existing sharing of ITC benefits. However, in TURN's view, the IRS has concluded that this shift improves the equity of the sharing. TURN recommends that the shift be made promptly.

3. <u>DRA's Position</u>

DRA framed much of its argument favoring adoption of interest synchronization around the controversy over adoption of the proposed Treasury Regulations published in June 1985. DRA indicated that the policy of this Commission at the time this record was heard favored adoption of interest synchronization for all regulated utilities. DRA cited D.86-02-030 issued February 5, 1986 in Sierra Pacific Power Company's general rate case proceeding. In that decision, we adopted DRA's interest synchronization proposal, stating:

> "...it is our intent that interest synchronization, should it be permitted by the U.S. Treasury regulations, should be applied to other California utilities. In order to assure that the benefits of this ratemaking treatment are passed along to ratepayers, we will move expeditiously to view this matter in a separate investigation to which all affected California utilities will be parties." (D.86-02-030, mimeo. p. 24.)

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3 Based on present ratemaking treatment amortizing the value of ITC over the average book life of Pacific Bell's plant and service-assuming 20 years.

Accordingly, DRA believed at the time the record was heard that this Commission had adopted a policy of applying interest synchronization case by case, as the issue came before it in current proceedings.

DRA's witness Infante recommended that, if the proposed Treasury regulations were adopted before a final decision was issued in this proceeding, the Commission should adopt them as applicable to the calculation of the interest deduction. In the alternative, if the Treasury Department had not acted upon the proposed regulations at the time this Commission issued its final decision, the Commission should adopt interest synchronization subject to recovery by Pacific Bell. The alternative, in DRA's view, was to set rates without interest synchronization and make them subject to refund if the regulation was later adopted. Since this places the burden on Pacific Bell's ratepayers, DRA recommends against this procedure because the proposed regulations indicate the intention of the IRS to adopt the regulation. Accordingly, at the time the record was submitted, DRA recommended that interest synchronization be adopted subject to recovery by Pacific Bell in the unlikely event that final Treasury regulations issued did not adopt interest synchronization.

DRA further noted that the Federal Energy Regulatory Commission (FERC) has imposed interest synchronization on the utilities it regulates since 1980, and that these FERC regulations apply to major gas and electric companies in California. DRA's witness Infante indicated that he had contacted his counterparts at California utilities subject to IRS Code § 46(f)(2), and had been informed by representatives of these Option 2 companies that they have complied with the FERC interest synchronization requirements since 1980. Apparently to this date there has been no objection to that method by the IRS as to these California utilities (65 TR 7832, 7837).

DRA also argues that Pacific Bell's opposition to interest synchronization appears to rest chiefly upon the assertion that the proposed regulations are violative of congressional intent. DRA believes that this position is contradicted by the IRS itself in issuance of the proposed regulations, and by Federal court cases cited in the proposed regulations. Moreover, the fact that FERC has imposed interest synchronization on California utilities subject to its jurisdiction since 1980 without any negative IRS reaction would seem to effectively counter Pacific Bell's argument.

4. Cities' Position

The Cities urge adoption of interest synchronization in determining Pacific Bell's revenue requirements as soon as possible.

Cities' recommendation is premised chiefly on the argument that interest synchronization recognizes the intent of Congress and achieves the proper sharing of ITC benefits. In support of its position, Cities quote extensively from two Federal appellate court decisions. The first is Union Electric Company v FERC, 668 F 2d 389 (8th Cir. (1981)) (hereinafter the (Union Electric case). In the Union Electric case, the appellate court found FERC's action in applying interest synchronization to be consistent with the applicable IRS regulations interpreting the Internal Revenue Code. The court discussed the appropriateness of the sharing concept as follows:

> "As explained above, both the utility and the ratepayers benefit from the credit under the FERC's method: The utility gets interest-free capital and the interest deduction leads to a lower cost of service and lower rates. Without such deductions, the ADITC (Accumulated Deferred Investment Tax Credit) would increase costs to ratepayers because the ADITC would swell the rate base on which ratepayers pay a return. The legislative history clearly shows that the customers are to receive a benefit from the credit. . . . The FERC's method

> achieves this goal and is consistent with the I.R.S. regulations; it allows a limited flow-through to consumers, and allows the remaining benefits to the investors or taxpayers, without requiring that all the benefits be allocated to the investors." (Id. at 395.)

Cities also note (as does DRA) that FERC has been using this method since 1980, with no adverse IRC ramifications.

In addition to recommending adoption of interest synchronization for Pacific Bell and all other California utilities at the first available opportunity, the Cities recommend the Commission order Pacific Bell to seek a favorable ruling from the IRS relative to the appropriateness of the use of interest synchronization for ratemaking purposes.

5. Pacific Bell's Position

Pacific Bell argues that the proposed interest synchronization methodology is fundamentally flawed from a ratemaking standpoint and should be rejected on that ground alone, without ever reaching Federal Income Tax eligibility questions. The heart of Pacific Bell's position is that the proposed IRS regulations are permissive in nature, not mandatory, and that this Commission should exercise its discretion in a manner consistent with its prior matching policy, enunciated in OII 24.

According to Pacific Bell:

> "It is certainly curious that the parties havechosen to completely ignore Decision No. 84-05-036, since that Decision was the culmination of a Commission-instituted investigation (OII 24) of the 'method to be utilized by the Commission to establish the proper level of income tax expense for ratemaking purposes of public utilities and other regulated entities.' That Decision contains statements throughout indicating that it is the Commission's consistent position that it calculates 'income taxes for ratemaking purposes based on the cost of service developed from adopted expenses...' (Decision No. 84-05-036, mimeo. p. 14; see also mimeo. pp. 12, 40-41). The Commission has reiterated this

policy in Decision No. 86-01-026 in this proceeding, where the Commission in the research tax credit area found as inappropriate the company's taking, for ratemaking purposes, a tax deduction for disallowed costs (Decision No. 86-01-026, mimeo. p. 70)." (Pacific Bell Opening Brief on the Interest Synchronization Issue, pp. 10 to 11).)

Essentially Pacific Bell argues that the interest synchronization adjustment is a ratemaking fiction or a "mythical interest deduction." It further argues the proposed IRS regulations themselves are inconsistent with the Internal Revenue Code, and therefore reliance on regulations poses eligibility risks. These risks are keyed to Pacific Bell's status as an Option 2 utility under § 46(f)(2) of the IRC.

Pacific Bell explains that it reduces its tax payments to the Federal Government by the amount of ITC applicable to new equipment, in the year in which the equipment is first placed in service. The amount of this tax savings is not flowed through immediately to ratepayers in the form of lower rates. However, the full amount of the tax savings is identified and is flowed through to ratepayers in the form of lower rates over the life of the equipment. The mechanism of § 46(f)(2), generally referred to as "ratable flow-through," gives to ratepayers the benefits of every dollar of tax savings attributable to ITC, but spread out evenly over the life of the equipment. Under § 46(f)(2), Pacific Bell is allowed to earn its authorized rate of return on the unamortized ITC balance until such amounts are flowed through to reduce cost of service. Therefore, Pacific Bell shares in the benefits of the ITC.

Pacific believes that there is no disagreement that the IRC mandates a sharing of ITC benefits between Pacific Bell and its ratepayers; all parties agree that this sharing is occurring without interest synchronization. Pacific Bell believes that its ratepayers are already receiving 51% of the benefits of ITC even

without interest synchronization, although there is a great deal of dispute about this from TURN's perspective (TURN reply brief p. 4). Pacific Bell argues that TURN, DRA, and the other parties are simply taking a position that the existing sharing should be tilted even more in favor of ratepayers. However, Pacific Bell believes that under § 46(f)(2), its eligibility for ITC will be lost if its cost of service for ratemaking purposes is reduced by more than a "ratable portion" of the ITC.

In Pacific Bell's view, the IRS analysis supporting the proposed regulations is highly questionable. Pacific Bell's witness Walker testified that the proposed regulations do violate § 46(f)(2).

Pacific Bell pinpoints various defects in the IRS' proposed regulations, arguing that the IRS statement that the cost of service reduction was not attributable to ITC is plainly wrong. Interest synchronization is obviously and inherently related to ITC in Pacific Bell's view. Since this IRS assertion is critical to the validity of the proposed regulations, if it is wrong, the regulations are subject to challenge.

Pacific Bell also faults the IRS comparison of rates established without interest synchronization vis-a-vis rates established if the credit were unavailable. According to the IRS this comparison would show that under certain factual circumstances the rates that would be established without synchronization may actually exceed in one or more service years the rates that would be established if the credit were unavailable. Based upon this comparison, the IRS estimates that a situation could exist where ITC was not benefitting ratepayers at all. Since Congress directed that benefits of ITC be shared, such a situation would not be consistent with Congressional intent. However, Pacific Bell's witness Walker testified that the IRS assertion had no applicability to the telecommunications industry in general, since an asset useful life of approximately 35 years would be necessary

before the IRS assertion could be true (Pacific Bell's average service life is approximately 20 years).[4]

Pacific Bell also argues that the cited Federal appellate court cases do not support the proposed regulations, principally because courts of general jurisdiction reviewing rate orders, and applying a reviewing standard that presumes the rate orders are valid, cannot be expected to be accepted as authorities on tax normalization issues.[5]

Pacific Bell also argues that, should the Commission decide that it wishes to adopt interest synchronization, it should not take any action that could jeopardize eligibility for ITC. The relatively small rate reduction does not justify the risk, especially when a mechanism exists that would preserve the benefits to ratepayers pending a final resolution of the present uncertainty. Pacific Bell believes ratepayers could be kept whole by putting interest synchronization into effect subject to refund. The triggering event for the ordering of refunds to customers could be the passage of a reasonable period of time, for example, one year, after regulations allowing interest synchronization are issued in final form. The one-year time frame would allow the

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4 TURN vigorously challenges witness Walker's argument on two grounds: First, there is no reason to believe that the factual assertion is crucial to the IRS reasoning. Second, there is no basis for believing that witness Walker's "analysis" is relevant, because he had no access to the IRS methodology, assumptions, or data used by the IRS in <u>its</u> analysis. (TURN concurrent opening brief on interest synchronization, p. 12.)

5 Both PSD and TURN challenged this view. PSD argues that the United States Courts of Appeals are courts of general jurisdiction. They are not uninformed with respect to tax matters because on appeal it is these courts that review rulings of the tax court (concurrent reply brief of PSD, p. 2).

Commission and the parties time to assess the likelihood that a challenge to the regulations might be made. If a serious challenge is mounted within that period, Pacific Bell could petition the Commission to delay ordering refunds pending the outcome of the challenge. In any event, Pacific Bell strenuously opposed implementation of interest synchronization subject to recovery.

A procedural dispute developed over Pacific Bell's position that the Commission should consider several other issues pending in Phase 2 in its interest synchronization calculation, assuming adoption. Specifically, Pacific Bell argues that the Commission must take account of the underutilization disallowance in any such calculation. Its view is that the weighted cost of debt used in any interest synchronization adjustment should be recalculated to reflect only the interest expense actually allowed in the authorized rate of return, as effectively adjusted pursuant to the underutilization disallowance (Exhibit 509, pp. 4 to 5). In Pacific Bell's view, to ignore the underutilization disallowance impacts is also contra to D.84-05-036 in OII 24, and the Interim Opinion (D.86-01-026) both of which make clear that tax benefits related to disallowed costs should not be taken into account for ratemaking purposes.

In addition, Pacific Bell argues that the Commission must take cognizance of the effects of the Remand Case Closing Agreement as an adjustment to the interest synchronization calculation. This apparently is omitted by DRA in its calculation.

Pacific Bell (formerly the Pacific Telephone and Telegraph Company) and the IRS entered into a closing agreement as a result of the litigation commonly referred to as the Remand Case. Essentially, Pacific Bell in settlement of IRS claims, paid $103.5 million because of the prior improper flow-through of investment tax credits to ratepayers (Exhibit 509, Attachment). At the same time, Pacific Bell agreed informally not to try and recover this amount from ratepayers. The TURN and DRA proposed interest

synchronization calculation subtracts unamortized investment tax credits from rate base as explained above. To include in this subtracted amount the moneys that Pacific Bell had to pay the IRS is incorrect, in the utility's view, because it never realized the $103.5 million as investment tax credits. Some $40.2 million of the $103.5 million remains to be amortized. This would properly reduce the proposed interest synchronization adjustment on an intrastate basis by $1.3 million (Exhibit 509, p. 3).

TURN objects strenuously to our consideration of Pacific Bell's arguments about the tax remand case and the impacts of the underutilization disallowance on the interest synchronization calculation. This was an issue that Pacific Bell injected into the record for the first time during hearings, and it was allowed in the record as supplemental direct testimony by the ALJ over the opposition of DRA and TURN, with allowance to the latter two parties to defer their cross-examination to a later date, to address the issue if they desired (TR. 7522; 7556; 7558). Neither DRA nor TURN indicated that they wished to take this opportunity, and therefore we will deny TURN's motion that these materials be stricken from the record. We believe the ALJ extended every opportunity to DRA and TURN to enable them to meet the issue.

We discuss the merits of Pacific Bell's supplemental direct testimony on these two issues subsequently.

D. Issuance of Final Regulations

On May 22, 1986, subsequent to the submission of the record on interest synchronization, the IRS adopted its final regulations (26 CFR part 1). By letter dated June 16, 1986, TURN asked that the Commission take official notice of these final regulations. On June 18, 1986 DRA filed a formal motion making the same request.

On June 26, 1986 Pacific Bell sent a letter to the assigned ALJ reiterating its position that the Commission should decline to adopt interest synchronization without reaching the tax

normalization issue. In Pacific Bell's view, the IRS regulations, whether in proposed or final form, should not be a deciding factor in the Commission's deliberations.

We will take official notice, pursuant to Rule 73, of the final Rules and Regulations issued by the IRS adopting amendments to the income tax regulations regarding interest synchronization.

E. Resolution of the Issue

Although much of the record in this portion of the proceeding focused on the proposed regulations, now final, we also need to address the more fundamental question raised by Pacific Bell: Is it a sound ratemaking policy to adopt interest synchronization for Pacific Bell?

On a generic basis we have already taken steps to ensure that interest synchronization is applied to so-called "Option 2" utilities. In October 1986, following issuance of the final IRS regulations the Commission issued I.86-10-002 requiring all option 2 public utilities to use the interest synchronization adjustment, on the rationale that this would enable ratepayers to more fully share in the benefits such utilities derive from ITC. Advice letter filings were required to reflect proposed implementation in each utility's next general rate case or attrition offset proceeding. Subsequently, appropriate adjustments have been made in such proceedings to reflect interest synchronization (see, e.g., D.86-11-079 for AT&T-C).

Thus, it is clear that the Commission in I.86-10-002 has resolved the policy-related sharing arguments in a manner contrary to the position advanced by Pacific Bell in this case. More specifically, based on the record before us, we conclude that adoption of interest synchronization for Pacific Bell, consistent with the IRS rules and regulations on point, will effectuate a better sharing of ITC benefits between ratepayers and shareholders. This record also provides ample basis for rejecting the sharing arguments presented by Pacific Bell's Walker, based on the

persuasiveness of TURN's arguments criticizing the methodology Walker used to try to distinguish telecommunications companies from other utilities.

Similarly, we were never persuaded by Pacific Bell's argument in favor of delaying rate reductions associated with the adoption of interest synchronization in order to allow a sufficient time to pass for legal challenge. There has been no such effort on the energy side from 1980 to the present time, as both DRA and TURN note in their briefs on this issue.

However, there are some issues we must still resolve based on this record. Pacific Bell is presently subject to a disallowance for "underutilization" of several plant categories. This disallowance was originally instituted by D.83-12-025 issued December 7, 1983 in a prior Pacific Bell rate case. It consists of a halving of the effective rate of return on nearly one-half billion dollars in plant; no adjustment to rate base or to any plant account is included. Therefore we reject the argument presented by Pacific Bell's Best that "disallowed interest expenses" be excluded from the interest synchronization adjustment. There is no indication that interest expense has actually been disallowed for accounting purposes in calculating either regulated books or income tax. The underutilization penalty is scaled to match plant amounts, but is not expressly related to any particular accounting treatment. Secondly, we agree with TURN that it would be ludicrous to allow Pacific Bell to save money from a newly adopted standard ratemaking treatment (interest synchronization) because of a ratemaking disallowance for imprudent management. This would be an inappropriate signal.

Similarly, with regard to the remand adjustment Pacific Bell presents an equitable argument that because it chose not to seek rate recovery of these dollars, it should receive the benefit of the $40.2 million remaining to be amortized. We reject this request for two reasons. First, Pacific Bell voluntarily opted not

to seek rate recovery for these amounts. We recognize that this presents an equitable argument; however, having made the conscious corporate decision not to seek rate recovery for these dollars, Pacific Bell should let the issue rest. Secondly, this is essentially an equitable argument, and we have balanced the equities in favor of the ratepayers who, after all, have waited several years since issuance of the proposed regulations in 1985 to finally see the impact of the interest synchronization adjustment in rates. The $1.3 million in issue pales by comparison.

Finally, there is an issue of timing. As noted previously, our interim decision as modified by D.86-03-049, set rates subject to refund to account for the interest synchronization adjustment as of March 5, 1986, the effective date of the latter decision. It is Pacific Bell's position that the interest synchronization adjustment should be made prospectively as of the date of this decision. However, in accordance with the arguments made by TURN in opposition to Pacific Bell's Application for Rehearing of D.86-01-026, and accepted by us in D.86-03-049, we will make the revenue requirement reduction associated with our adoption of interest synchronization effective from March 5, 1986. The impact on Pacific Bell's test year revenue requirement, after taking into account our disposition of the disputed Phase 2 issues, is ($28,653,000) as shown in Table A, Exhibit 754 (supra p. 9).

V. The Marketing Abuse Issue

A. Background

The marketing abuse issue initially surfaced when DRA released prepared testimony in this proceeding on April 21, 1986, further expanding on testimony it had released in December 1985. This testimony detailed marketing activities subsequently found to violate PU Code § 532, General Order 153, and Tariff Rules 6 and 12. The Commission quickly responded to release of this testimony

by issuing an order to show cause (OSC) on May 7, 1986, setting hearings on this matter (D.86-05-051). The evidence adduced at these hearings demonstrated that the abuses were extensive. We made the following Findings of Fact in our cease and desist order (D.86-05-072) subsequently issued:

> "1. An investigation conducted by DRA indicates that Pacific Bell has conducted a 30-day trial program in Southern California for enhanced services, without benefit of a tariff relative to such trial program.
>
> "2. DRA's investigation indicates Pacific Bell service representatives were representing to applicants for new flat rate service or new measured rate service that such service was part of a package, in connection with an array of activities that have been referred to generically in this proceeding as 'package selling'.
>
> "3. DRA's investigation indicates that Pacific Bell's service representatives have been improperly applying the criteria in the utility's filed tariff, Rule 6, relative to establishment and re-establishment of credit, more specifically the criteria regarding waiver of deposits.
>
> "4. DRA's investigation indicates that Pacific Bell service representatives have been improperly applying the procedures for administration of the Moore Universal Telephone Service Act.
>
> "5. Pacific Bell recently sent a bill insert to its customers which referred to local measured service as 'Standard Service' and flat rate service as 'Premium Service'; these references were incorrect and may lead to customer confusion.
>
> "6. Pacific Bell offers three types of basic service, which are correctly referenced as Universal Lifeline Service, Local Measured Service, and Flat Rate Service.

> "7. The activities detailed in the previous findings of fact were carried out under the directives of Pacific Bell's management personnel who had direct responsibility in the marketing of services to residential and business customers; indeed such programs as the sales quotas and telemarketing activities, carried out under management's direction, substantially contributed to the marketing abuses discovered during DRA's investigation." (D.86-05-072, mimeo. pp. 17 to 18).

We also made the following Conclusions of Law in connection with our cease and desist order.

> "1. Pacific Bell violated PU Code § 532 by conducting an unauthorized trial program relative to enhanced services.
>
> "2. In its 'package selling' efforts, Pacific Bell violated Tariff Rule 12 which requires a quotation or full itemization of recurring and nonrecurring charges applicable to the service and equipment a customer seeks.
>
> "3. Pacific Bell violated Tariff Rule 6 relative to establishment and re-establishment of credit, by applying the deposit waiver provisions of the tariff inconsistently and by failing to give certain customers the benefit of the waiver provision in accordance with the terms of the tariff.
>
> "4. Pacific Bell violated Section 1.3.21 of GO 153, the procedure for administration of the Moore Universal Telephone Service Act, by improperly applying the definitional criteria for lifeline service eligibility.
>
> "5. Pacific Bell should be ordered to cease and desist from the violations of PU Code § 532, GO 153, and Tariff Rules 6 and 12, noted above.
>
> "6. Pacific Bell should be ordered to cease all activities in furtherance of its so-called

'branding' or renaming of basic telephone services.

"7. Workshops should be held to resolve certain immediate issues regarding customer notification, refunds, and other appropriate adjustments flowing from the abuses identified in this record.

"8. Workshops should be held to develop a proposal for establishment of a customer marketing oversight committee, as discussed in this opinion.

"9. Pacific Bell should be ordered to cease its cold-selling telemarketing activities and discontinue its sales quota program until further order of this Commission, following review of these practices by the customer marketing oversight committee." (D.86-05-072, mimeo. pp. 18 to 19).

The workshops ordered in the cease and desist order were held under the general guidance of the Commission Advisory and Compliance (CACD) Division staff in June of 1986. Workshop participants included representatives of Pacific Bell, various Commission staff divisions (DRA, CACD, Consumer Affairs Branch, and the Public Advisor's office), TURN, Public Advocates, and Centex Telecommunications. Under the guidelines provided by the Commission in the cease and desist order, the workshop participants negotiated a plan for customer notification, refunds, and other adjustments. This plan (referred to as the CNP) was structured to include various media, including print, advertising, radio spots, direct mail, direct customer contact, and bill inserts.

Because various workshop participants expressed qualms about the sterility of the language Pacific Bell insisted on using to convey the message of the CNP, our approval was conditioned on establishment of a tracking mechanism (discussed subsequently) and reservation of the option of reconvening workshops. We defined customer's eligible for refunds as those residential and business

customers who changed service after January 1, 1985 and who were subject to the marketing abuses identified in the record, and residence customers who paid an $80 deposit after September 1, 1985 due to incorrect application of Tariff Rule 6. We also provided that the costs and expenses of the CNP were appropriately borne by Pacific Bell's shareholders, due to the underlying nature of the marketing abuses which triggered the need for the CNP, and due to the fact that the CNP merely remedied past abuses and restored affected customers to the position they would have enjoyed "but for" such abuses. We also determined that it was reasonable to establish a mechanism for tracking the costs, expenses, and overheads of the proposal in its beginning stages in order to ensure that such costs are borne by shareholders, and that such extraordinary costs and revenue impacts do not affect future test-year projections. We provided for interest at the rate of 7% per annum on all amounts refunded pursuant to the order. We also ordered Pacific Bell to accelerate the timing for implementing itemized monthly bills, in order to prevent recurrence of these abuses by promoting customer understanding of basic telephone service billings.

Finally, we determined in connection with lifeline issues that Pacific Bell had made reasonable efforts subsequent to the cease and desist order to ensure that its customer representatives were adequately trained in the workings of General Order 153, as demonstrated by Pacific Bell's compliance filing required by Ordering Paragraph 7 of the cease and desist order. However, we indicated the appropriateness of monitoring these activities in the future and indicated that the matter would be referred to the Customer Marketing Oversight Committee (CMOC) for further review.

At the time we issued our CNP order in August 1986, the CMOC workshops had not concluded and the workshop report was not yet available; therefore, we deferred the issue of CMOC; however, we resolve that issue in today's opinion.

Finally, in our overall handling of this marketing abuse question, we opted to defer for further Phase 2 consideration the issue of DRA's recommended $49.5 million penalty. We also resolve that issue in today's opinion.

B. Further Phase 2 Issues Framed

We were very clear in our August 1986 CNP decision that the Commission-mandated customer notification and refund plan was designed as a restitutionary remedy. As we stated in that decision:

> "The subject of today's order is the actual implementation of the notification and refund mechanism which will provide an immediate remedy to affected ratepayers. It is fundamentally clear that were it not for the violations of statute, general order and tariff provisions cited in D.86-05-072, none of the costs or expenses to be incurred as a result of today's order, and required to implement the notice and refund program, would have been incurred. Simply stated, there is no reason to require that any of the costs of the remedial notice and refund program be borne by ratepayers who did not cause the cost of the program, and who will receive no additional benefits from the program, but will merely be restored to the position they would have enjoyed but for these marketing abuses. For this reason, separate and apart from any 'penalty' overtones, these costs should be borne by shareholders." (D.86-08-026, mimeo. pp. 19 to 20).

In reviewing the overall question of how effective this remedial approach has been, as well as the question of appropriate other remedies, we must necessarily review the known results of the CNP program. We also review various proposals addressing whether that remedial mechanism should remain in place for the immediate future.

But we also confront the question whether "appropriate remedies" includes imposition of a penalty, going beyond the restitutionary remedy that we have already ordered for the benefit

of ratepayers. Such a "penalty" would be designed to deter similar future activities, to serve as a warning to other utilities that such marketing abuses are intolerable, and to prevent unjust enrichment of the utility.

C. Positions of the Parties

1. DRA's Recommendations

On the basis that Pacific Bell's abusive marketing practices were extensive and harmed a significant number of its residential customers and some business customers, DRA believes that Pacific Bell will be unable to totally remedy the harm done. The refund of dollars cannot be considered an adequate remedy for those persons who were unable to obtain telephone service due to improper marketing of Universal Lifeline Service or improper application of the credit rule criteria. Moreover, monetary remuneration in the form of refunds does not reflect the hardships imposed on those customers who did obtain telephone service, but had to make unwarranted financial sacrifices in order to obtain that service. Finally, DRA does not believe that the utility will ever be able to "reach" all of those customers who were impacted by these practices.

The extensive nature of these abuses is evidenced by the fact that as of February 1, 1986 (the date that DRA filed its opening brief), over 289,200 residential customers and 7,900 business customers had been refunded approximately $27.5 million (Exhibit 720A, p. 720A(2)).

Based upon information presented in the mandated tracking studies, including the Field Research Corporation (FRC) Responder/Nonresponder Survey (Exhibit 725A), DRA believes that these figures represent only one-half of the potential residential customers who are entitled to some form of refund. This statement is based on FRC's finding that about one-fourth to one-third of those who have one or more services that they don't want have already done something about it, and another one-third to one-half

plan to do something. Thus, assuming only one-half of this latter group have in fact acted, which DRA believes is a conservative assumption, about one-half of the residential customers who are entitled to a refund have yet to take any action.

DRA reminds us of the likelihood that these practices were going on prior to January 1, 1985, and notes that refunds have been made by the utility to customers who alleged that unethical marketing practices were occurring as far back as September 1983 (Exhibit 723A, p. 2). Moreover, staff believes that many of the abusive marketing practices which were discovered in the Residence Marketing organization are likely to have been practiced on business customers up to at least May 16, 1986, the date on which Pacific Bell initiated a moratorium on such activities.

These unethical marketing practices were apparently fostered by sales quotas which rewarded sales representatives for selling products rather than assuring the provision of proper service (Exhibit 586, p. 14). Customers, who presumably called Pacific Bell to make arrangements for telephone service and who expected complete and accurate information and advice, were instead intentionally misinformed by Pacific Bell's sales representatives. Office Managers' yearly bonuses were partially based on meeting quotas for that year, and service representatives who did not meet their quotas were reprimanded and given a bad performance evaluation. In fact, bad performance evaluations spanning three or four months could result in the firing of a service representative. (Exhibit 329, p. 12-6).

Further, DRA reminds us that we explicitly found in the cease and desist order that these practices were an expression of Pacific Bell's overall marketing policies:

> "The record clearly demonstrates that, far from being isolated occurrences at lower levels of the employee ranks, the abuses chronicled by our staff were part of an overall policy pursued by overzealous sales management which apparently lost sight of Pacific Bell's

> obligations as a monopoly public utility. This was a serious violation of the public trust. Many of the abuses identified in this proceeding would not be tolerated in a competitive environment, where customers have recourse to alternative service providers and may express their dissatisfaction in that fashion. Pacific Bell's monopoly over local exchange service effectively precludes this remedy for its ratepayers, who may have been victimized by a misguided and irresponsible sales policy. In short, it was a policy which necessarily emphasized sales over service--to the ultimate detriment of Pacific Bell's captive ratepayers." (D.86-05-072, mimeo. p. 13.)

DRA's recommended penalty focuses on the marketing organization in an explicit fashion. It is a base penalty, related to the estimated salaries, including pensions and benefits, of the managers and company officers who have direct responsibility for residence marketing activities; it also includes an additional penalty to reflect the lack of oversight by higher management. DRA has estimated that on a test-year annual basis, such a penalty would approximate $16.5 million, based on a reduction in net revenues for Pacific Bell of $8 million. This $8 million reflects salaries and benefits of Pacific Bell's Vice President--Consumer Market through the manager levels in the various segments of the Consumer Market organization, including the Residence Telephone Order Center (RTOC) managers (Exhibit 588, p. DMS-12).

This is a penalty in gross revenues, rather than a penalty based on disallowance of $8 million in salaries and benefits as an expense. Additionally, DRA urges the Commission to triple the proposed $16.5 million base amount to accurately reflect the failure of Pacific Bell's upper management and board of directors to properly oversee the marketing organization. DRA recommends that the penalty remain in effect for a minimum of 12 months. Pacific should not be allowed, in DRA's view, to come before the Commission in two or three months and allege compliance

as a means to avoid a substantial portion of the penalty. The penalty should remain in place for a 12-month period in order to equate to a substantial portion of the period over which the marketing abuses occurred. DRA recommends that the penalty be removed only after an affirmative showing by Pacific Bell that the abusive tactics have been eliminated and that Pacific Bell's activities are in full compliance with the relevant tariffs.

DRA strongly urges imposition of a financial penalty based on Pacific Bell's breach of its obligation to provide public utility services without deception. DRA believes the Commission must send out a signal that discourages such outrageous conduct in the future.

DRA does acknowledge that Pacific Bell's substantial efforts to remedy the impacts of its abusive marketing practices and to regain the public trust may merit mitigation of any penalty imposed. If the Commission finds that Pacific Bell's remedial efforts have been substantial and meaningful, and that Pacific Bell is now operating in substantial compliance with all applicable statutes, General Orders, and its own tariffs, the Commission would be justified in reducing DRA's recommended financial penalty from $49.5 to $16.5 million.

Nonetheless, DRA remains adamant that some sort of penalty should be imposed. It believes that Pacific Bell has downplayed the pervasiveness of these abuses. Further, the utility failed to heed early warnings and correct these abuses when they first became public during State legislative hearings and as a result of the mailing of DRA exhibits during late 1985. DRA asserts that the failure to respond early to these warning signs does not bode well for the future, despite Pacific Bell's assertions to the contrary.

DRA recommends that prior to determining the level of any penalty, the Commission should require Pacific Bell to undertake an additional customer notification campaign, based on the results of

the FRC's survey indicating the failure of the current CNP to reach all affected customers.

2. TURN's Recommendations

TURN makes several recommendations for further remedies, including imposition of additional penalties based on the argument that the cease and desist order did not end all abusive marketing practices, and additional recommendations with regard to the CNP/workshop mechanism.

TURN notes DRA's Shantz has projected that Pacific Bell's "ill-gotten gains" associated with these marketing abuses approximate $41.6 million.[6] As of the date hearings concluded and briefs were submitted, Pacific Bell had refunded $27.5 million. TURN notes that this figure does not include customers who corrected the matter themselves (those who resorted to self-help when they realized their bills were inflated). It further notes that the record in this case demonstrates a substantial out-migration from two of the multi-service packages involved in these abuses. For example, nearly 20,000 customers canceled the four-CCS package in April and May, the two months that ended with the cease and desist decision. This is ten times the out-migration of other CCS packages. TURN believes that this evidence provides clear indication that additional tens of thousands of customers were initially victimized by Pacific Bell's abusive marketing practices, but rectified their problems too early to show up in the tracking associated with the CNP.

6 In Appendix A to Exhibit 589, PSD Shantz reviewed revenue from custom-calling services and call bonus/wide area services, estimating that 25% of these services were unwanted and projecting ill-gotten gains of $41.6 million.

The second point TURN makes is that some customers will never respond. Research by Pacific Bell indicates that only two-thirds of its residential customers were even aware of the CNP mailings. The tracking surveys strongly suggest that tens of thousands of customers are still providing the utility with ill-gotten gains. This possibility leads to TURN's third point: that response and refunds under the CNP guidelines can be expected to continue, assuming that the refund program also continues. Implementaton by Pacific Bell of itemized billing (required by D.86-08-026 and Resolution No. T-12001, dated February 11, 1987), can also be expected to stimulate further customer inquiries and refunds.

TURN believes that these three sets of observations demonstrate that a $49.5 million penalty, as recommended by DRA, is reasonable. Well over 300,000 customers have been directly harmed, (297,000 documented victims, plus the self-helpers plus the not-yet helped). Disgorged "ill-gotten gains" undoubtedly exceed $30 million ($27.5 million documented plus tens of thousands of dollars of refunds to self-helpers (presumably smaller than the median $101.43 CNP refunds, since customers caught the problem quickly), plus as many as 150,000 still deceived customers). The proposed penalty is indeed comparable to the excess revenue Pacific Bell would have accrued in each year of undiscovered wrong-doing.

TURN asks that DRA's recommended $49.5 million penalty be imposed, and that the implementing rate adjustment remain in place long enough to ensure that the full amount is in fact passed through to ratepayers as a reduction to gross revenues. TURN opposes DRA's uniform surcharge proposal as a mechanism for implementing the penalty on the basis that it would give business customers some 40 times their fair share of penalty benefits, to the disadvantage of residential customers. TURN recommends that the penalty be exacted by a specifically delineated line item rate reduction made to each residence access line. The billing

mechanism necessary to do this would be comparable to the method presently used for the FCC access charge, which is levied on a per-line basis. The amount of the offset could be estimated easily from adopted residence access line volumes and the amount of the penalty spread over as many months as this Commission deems appropriate.

TURN also recommends that the Commission take additional punitive measures, based on its "Motion for a Commission Order Finding Pacific Bell in Contempt of Cease and Desist Order D.86-05-072" filed October 27, 1986. TURN'S motion addresses two practices unearthed during further Phase 2 hearings on the penalty issue. The first practice is categorized by TURN as a further variation on the "cold selling" theme. Under this scenario customers calling 611 repair service representatives to report service problems were asked "do you want to save money on your phone bill?" The names of customers who said "yes" were referred to marketing representatives, who then called these customers and sold not only call bonus plans but enhanced custom calling features as well (TR. 14293-14297). Once this practice was disclosed on the record during testimony of DRA's Miller, Pacific Bell acted immediately to stop it. Nonetheless, on the basis that this practice persisted for five months after the issuance of our cease and desist order, TURN believes it demonstrates Pacific Bell was in contempt of D.86-05-072.

Miller also cited internal Pacific Bell communications regarding revenue generation from 411 directory assistance activities. However, she had not had an opportunity to pursue this issue by the time hearings were held. Counsel for Pacific Bell then offered an unsworn assertion that no such activities were actually taking place (TR. 14307), and the issue was dropped. TURN raises it again in support of the argument that an additional penalty should be imposed.

Finally, TURN alleges that "branding," or mislabeling of services, continued after the cease and desist order. During the May OSC hearing, TURN cross-examined Pacific Bell's witness Haight, questioning whether any of Pacific Bell's white or yellow page directories included references to mislabeled services. Haight did not have any detailed knowledge, but indicated that any such problems would be corrected (TR. 8020-8023). Thereafter, in this further penalty phase, TURN introduced Exhibit 607, showing a mislabeled page from the September 1986 San Francisco telephone directory. A subsequent transcript request by TURN revealed that 2.8 million mislabeled directories were sent out after issuance of the cease and desist order. While these directories closed for publication no later than July 31, 1986--over two months after issuance of the cease and desist order--they were delivered as late as September 24, 1986--four months after issuance of the cease and desist order. Pacific Bell's Sullivan asserted that the error was inconsequential (TR. 14822), but he later met with TURN and negotiated the text of a corrective insert which was sent to all customers receiving the affected directories and to millions more who had received similarly mislabeled directories in the months preceding the cease and desist order. As TURN notes, this broader mailing was necessary because every directory sent out by Pacific Bell during 1985 to 1986 had been mislabeled with the unauthorized "Premium (unmeasured)" and "Standard (measured)" terminology.

TURN acknowledges that Pacific Bell was extremely responsive in correcting these problems once the Commission had been informed of them during these further hearings. It believes, however, that the crucial point is that Pacific Bell itself was unable or unwilling to police its own customer service or directory publishing units so as to identify and correct these ongoing problems. TURN asks the Commission to enter a formal finding that the 611 referral and branded directories constitute violations of the cease and desist order, and further that Pacific Bell was in

contempt of the cease and desist order at least through October 1986. An additional $50 million penalty should be imposed for these contempts, TURN's view.

TURN also believes the Commission should create a residential "Consumer Advocacy Trust Fund" (CATF) to be funded initially by the utility at a level of $1 for each Pacific Bell residential customer. This amount--some $7.5 million based on 1987 customer volumes--would be deducted from the penalty amount ultimately imposed on Pacific Bell. Consumers would apply for an up-front grant from the CATF to finance specific oversight and advocacy activities before the Commission. TURN supports CATF on four bases.

First, it notes that ample precedent exists under Clam v CPUC (1979) 25 Cal 3d 891, and the PURPA rules (the so-called Article 18.5 rules, since expanded to a broad range of proceedings via Article 18.6 and 18.7).

Second, TURN believes that the Commission's existing advocate compensation rules, which operate on an after-the-fact basis, handicap the Commission's oft-stated policy of encouraging diverse and well-rounded participation in its proceedings. These limitations are exacerbated by frequent time lags between substantive decisions and compensation awards.

Third, so-called "up-front funding" would allow greater participation.

Fourth, CATF would provide a uniquely beneficial use for penalty monies that might be exacted from Pacific Bell. Most broadly, TURN submits that the fund would provide a more lasting legacy for residential ratepayers than would short-term pass-through of all penalty dollars in one year or less. The fund would also help address the narrower problem created by the ongoing need of consumer groups who monitor Pacific Bell's residential marketing activities. TURN claims to have been stretched by the demands of attending CNP/workshop meetings. Finally, TURN believes that CATF

would allow groups like TURN to investigate independently allegations of abusive marketing. TURN had heard complaints of such activities during 1985 and 1986 (Exhibit 516), but lacked the resources to assign staff to undertake an investigation similar to that DRA's Miller eventually conducted. TURN is now restricted similarly from pursuing reported abuses in the areas of IWM and equal access marketing.

Separate from its penalty recommendations, TURN offers several other suggestions for improving oversight of Pacific Bell's marketing activities. TURN believes that the workshop mechanism has been very effective in overseeing the development of CNP. TURN requests specific findings and Commission directives affirming that:

- The purpose of the CNP and workshops is to expedite the design and preparation of remedial actions directed to making whole customers harmed by Pacific Bell's abusive marketing practices.

- CNP efforts were necessarily of uncertain effectiveness when initially developed, as they evolved from a consensus of interested parties addressing complicated issues of customer notification and response.

- Findings presented in tracking reports commissioned by Pacific Bell indicate that the CNP approved in D.86-08-026 has not yet achieved adequate levels of notification, rectification, and refund.

- In order to allow the most effective and expeditious development of further improvements to the CNP, the Commission should affirm the desirability of Pacific Bell developing and testing further informational and corrective measures agreed to by the workshop participants, without the requirement of prior ALJ ruling or Commission decision.

- Pacific Bell should be directed to develop and implement effective further notification measures that will link the new itemized

billing to the continued availability of refunds under guidelines already developed for the CNP.

- The Commission should make clear that the CNP/workshop mechanism is to continue until terminated by Commission order, and should make express provision for an eventual joint filing by workshop participants to terminate the mechanism.

- The Commission should determine the status, role, and membership of the long-pending CMOC, including what relationship the Committee may have with the CNP/workshop mechanism.

In conclusion, TURN believes that the CNP/workshop mechanism continues to be a powerful tool for undoing the financial and attitudinal harm created by the problem; TURN therefore, recommends that this mechanism be retained with a clearly defined mandate.

3. Public Advocates' Recommendations

Public Advocates presents a bleak picture of the success of the CNP. Public Advocates reminds us that Pacific Bell initiated the CNP fully accepting the risk that an additional notification campaign might be necessary should the tracking data demonstrate the need for one (TR. 19197-19200; D.86-08-020, mimeo. p. 8). According to Public Advocates, the now completed Field Research Study (Exhibit 725A) clearly demonstrates the enormous extent of the marketing abuse, the inadequacy of the purposefully low-key refund campaign, and the failure of Pacific Bell to provide refunds to 800,000 of its most vulnerable customers who presently have services they didn't ask for, cannot use, and/or are unaware they have. To appreciate the enormity of Pacific Bell's abusive actions, Public Advocates asks us to consider that the total minimum number of customers still due refunds exceeds the aggregate of all Pacific Bell residential customers in San Francisco, Oakland, and San Jose.

Public Advocates asserts that 800,000 customers (20% of Pacific Bell's residential customers who received an itemized letter) were unaware of one or more optional services they have, even after receiving the itemized refund notice. Public Advocates then calculates the total minimum refund due these customers as $31.5 million ($29.4 million plus interest at 7%, totalling $2.1 million). In addition, Public Advocates asserts that this $31.5 million figure does not include $28.4 million potential lifeline refunds and refunds due unaware customers.

Public Advocates also asserts that the Field Research data demonstrate that low income and minority ratepayers were special targets of the marketing abuses, especially those abuses keyed to the optional package.

Public Advocates contends that in the absence of additional corrective action, such as a new refund campaign, at least 800,000 residential customers will continue to pay $29.4 million per year for services they are unaware of, and presumably don't want or need. Thus, Public Advocates estimates that, over the next three years, Pacific Bell could receive a windfall from its past abusive tactics of $88 million.

Public Advocates also stresses the plight of lifeline eligible customers, asserting that the tracking data indicate only one in three of these customers knew and understood lifeline service. It is impossible, however, to determine with certainty the dollar amount of potential additional lifeline refunds, due principally to the extensive changes in the nature of lifeline service over its period of existence. Again, Public Advocates asserts that the past refund campaign is inadequate to address the lifeline problem, since lifeline-related abuses resulted in refunds of just $1.5 million (Exhibit 725A).

Given the limited success of the refund campaign, Public Advocates asserts that a new refund campaign should be required. Pacific Bell also apparently recognizes the need for such an

additional effort. On March 9, 1987, Pacific Bell convened a meeting to announce its intention to engage in an additional refund campaign. Public Advocates views this as most commendable. Due to the shortage of time from receipt of the Field Research conclusions and the due date for briefing in Phase 2, Public Advocates has included in its brief suggestions about the scope and structure of this additional effort.

Ideally, Pacific Bell should be required to personally call all customers who have optional services and have not sought a refund, to inquire as to the customers' knowledge and need for these services. As an acceptable alternative, such personal customer calling might be limited to those who secured optional services after January 1985, with particular emphasis on the most abused population (383,000 low income and almost 500,000 minority unaware customers). To supplement this personal customer calling, Public Advocates urges that Pacific Bell mount a multilingual "red circle campaign" along the lines of the red lettered inside wiring campaign. For the next four billing cycles Pacific Bell would be required to take the following action:

a. Circle in red all optional services;

b. Prominently, on the first page of the bill, in red, urge all customers to look at their bill to see if anything is marked in red;

c. Include a prominent and simple notice of the potential for a refund;

d. <u>All</u> information should be in at least Spanish;

e. The envelope, modeled after the inside wiring campaign, should inform customers, in bold red letters, at least for the first billing cycle, of the possibility of a refund; and

f. Multilingual "800" numbers should be set up to answer customer questions.

In addition, given the demonstrated efficacy of radio and television ads, dramatic red circle radio and television advertising should be undertaken as well as newspaper advertising in foreign languages. If the above campaign is undertaken, Public Advocates believes a separate refund insert may be unnecessary, although Public Advocates has no objection to such an insert if it is simple, multilingual, and clear in purpose.

Given its assertion that an additional lifeline-related refund campaign could be confusing and perhaps unfair to Pacific Bell (due to the changing nature of lifeline service during the 1985-1987 time frame), Public Advocates recommends alternatively that Pacific Bell (in cooperation with Public Advocates and low income groups) conduct an extensive campaign to encourage low-income persons to secure lifeline service. The minimum goal should be to have 75% of all eligible low-income Pacific Bell customers using lifeline service within 12 months. At present, less than one-third of all eligible Pacific Bell customers have lifeline service. The suggested 12-month campaign should produce a minimum of 750,000 new lifeline customers.

If such efforts are undertaken, Public Advocates recommends that any penalty should be modest and benefit the victims of the abuse. Public Advocates recommends a specific rather than a general penalty in the range of $7.5 to $15 million.

Public Advocates argues that a general penalty could reduce residential rates by a trivial amount per customer (for example a $23 million general penalty would have an approximate effect of 25-cents per month for one year). In addition, such a general penalty would not be targeted to reach those who actually suffered harm, but would benefit other ratepayers who suffered no harm or who have already received refunds. It is estimated that approximately 75% of all ratepayers either suffered no harm or have received refunds.

More specifically, Public Advocates believes that the primary purposes of a penalty should be to: discourage similar future activities, serve as a warning to others, and prevent unjust enrichment. A specific (versus general) penalty can achieve the general penalty purposes and at the same time maximize future benefits and ratepayer protections. Public Advocates urges a specific "educate the ratepayer penalty" of $7.5 million to $15 million be imposed on Pacific Bell to primarily benefit those who have been most harmed by the marketing abuses and who are most likely in the future to be victims of increasingly complex utility services. This is especially important given the unlikelihood of totally identifying and reimbursing all ratepayer victims.

The heart of the recommendation is that Pacific Bell contribute between one to two dollars per residential customer ($7.5 to $15 million) to an independent ratepayer research and educational institute, or comparable body, as an alternative to a larger general penalty. This institute would be totally independent of Public Advocates, TURN, or any other existing organization. Its Board of Directors would be appointed primarily by the Commission, with additional members nominated by Pacific Bell and/or consumer groups, subject to Commission approval.

Public Advocates asserts that the California Supreme Court has strongly approved such a method in cases where it is difficult to identify victims of consumer fraud (State of California v Levi Strauss and Company 41 Cal 3d 460 (1968)).

Public Advocates also cites the Virginia Environmental Endowment, created as a result of Federal court litigation involving Allied Chemical Corporation. Allied Chemical was fined $13.2 million for polluting the James River with Kepone. Instead of automatically requiring Allied Chemical to pay this fine, the Federal District Court Judge encouraged the development of an independent environmental fund to benefit all residents of Virginia who had been victims of the defendant's actions. Allied Chemical

accepted the Court's suggestion and made a contribution of $8 million.

Alternatively, Public Advocates suggests that the Commission consider the course adopted in People v Occidental Petroleum Corp., Civ. 5-79-989 MLS (E.D.Cal.), wherein instead of requiring Occidental to create a separate fund, the Court compelled it to contribute an annual sum until the year 2000 to universities within California for environmental research. Public Advocates maintains that a similar contribution might, for example, be made to Consumers Union or the California Consumer Federation.

The underlying premise of Public Advocates' recommendation is that this specific future-oriented penalty would produce a far more informed, educated, and protected ratepayer public at a time of increasing regulatory complexity, and would, therefore, reduce the need for additional regulatory protection. It is far preferable to have a well-informed ratepayer public that can protect itself than to have an intrusive regulatory process that assumes an uninformed and uneducated public.

In its reply brief, Public Advocates recommended that the Commission refrain from making a final decision on the penalty issue until the results of the second refund campaign are known, arguing that the penalty issue cannot be decided until the results of that campaign are apparent. This is consistent with a similar recommendation made by DRA.

4. Pacific Bell's Recommendation

Pacific Bell claims that its first awareness of the marketing abuse problem is traceable to the end of 1985 when DRA's report was released, although the problem became more apparent in April 1986 with issuance of the supplemental testimony of DRA's Miller and Shantz. While quibbling about Miller's "unscientific" study, Pacific Bell does acknowledge that DRA's showing at the hearings on the Order to Show Cause indicated the existence of a problem. It expresses some disagreement about the magnitude and

scope of the problem, but indicates that "...Pacific Bell was committed to finding and implementing a solution to whatever problem existed, despite its disagreement as to the extent of the problem." (Pacific Bell opening brief, p. 344.)

Pacific Bell chronicles the decisions rendered by the Commission in this matter and its compliance with the extensive requirements imposed by those decisions.

It lists the steps it has undertaken to correct its marketing practices. Those activities primarily involve improvement of internal communications and procedures. In addition, Pacific Bell maintains it was completely cooperative with DRA (TR. 14320), and was a key player in the Commission-ordered CNP workshops. It also implemented the extensive CNP in accordance with the Commission's directives in D.86-08-026, and worked extensively with community organizations, while increasing its CNP media advertising as well.

Pacific Bell has also implemented the massive refund plan ordered by the Commission. (Exhibit 720A demonstrates it sent a general self-mailer to over 4.2 million customers and an itemized letter to over 4.2 million customers, for a total of nearly 8.5 million customers.) Residence customers received notification messages in five languages: English, Spanish, Korean, Chinese, and Vietnamese. Customers were encouraged to respond in several different ways (reply cards; an 800 number which was especially established to receive toll-free calls from customers who had either heard or seen one of the CNP advertisements; and third, direct responses initiated by customers calling one of Pacific Bell's business offices).

By the time the record closed the CNP had refunded over $27.5 million, at a cost of over $11.3 million. Thus the total cost of CNP up to that point in time (including refunds and expenses) was nearly $39 million.

The FRC and Elrick and Lavidge, Inc. Tracking Surveys, ordered by the Commission, were designed to ascertain CNP's success. In addition, besides the CNP itself, Pacific Bell at the Commission's direction has implemented itemized billing, which will increase customer awareness.

In sum, Pacific Bell states:

> ". . . All customers, over 7.5 million residence and almost one million business, have been sent notifications explaining how they could obtain refunds for any unwanted or unordered services, in accordance with the wishes of the workshop members and the Commission. The customers have responded in sufficient degree to indicate that the CNP has been an effective and appropriate means to provide customers with recompense. Most importantly, the concerns raised by the parties regarding Pacific's marketing activities have been addressed and corrected. There is no evidence that the problems will ever resurface; indeed, they will not reoccur. The concerns of the Commission have been taken care of to the benefit of all." (Pacific Bell opening brief, p. 356.)

Pacific Bell asserts that DRA's penalty recommendation should be rejected on several grounds. First of all, Pacific Bell believes that it is arbitrarily calculated, via the tripling of the $16.5 million revenue requirement associated with the base amount. Also, the DRA penalty is excessive and inconsistent with the original recommendation made by DRA in its prefiled testimony, where the penalty was framed alternatively with other types of remedies, such as customer refunds. Pacific Bell believes that any penalty in addition to CNP costs already incurred would not only be excessively punitive but would serve no purpose and be of no benefit to California ratepayers. Furthermore, Pacific Bell maintains that it has already received a substantial penalty counted in actual expense dollars and in detriment to its reputation. According to Pacific Bell's Sullivan:

> "We spend a lot of time and effort trying to convince our internal and external publics of the highly ethical, highly responsible public service type of organization we want to be. The allegations that have been made regarding sales practices have been very costly to us in terms of our credibility with our employees, our credibility within the community, with our residence customers and with other markets. Certainly the publicity attendent to these allegations have been registered in the media. They have been widespread. They have caused us great concern. We are doing everything we know how to rectify that. And it is not a cheap undertaking. It is costly in terms of reputation. And it is costly in terms of trying to win back that reputation...[the dollar value of the tarnishing of Pacific's reputation] is so deep-seated, it is such a basic concern of most of us, certainly the people I deal with on a day-to-day basis, I just can't put a price tag on it. (124 TR. 14809-10).

Pacific Bell believes that the assessment of a penalty in addition to the already ordered refunds and below the line expense treatment associated with the CNP would place the company in "double jeopardy." In addition, it criticizes DRA for not considering the effects of subsequent CNP developments and Pacific Bell's efforts to mitigate the damage.

The CNP results (costs plus refunds) totaled $38.9 million as of the briefing date, very close to DRA's original $49.5 million recommendation. Pacific Bell sees no need for anything additional. If anything at all additional is ordered, Pacific Bell believes the Commission could deduct the $38.9 million from DRA's recommended $49.5 to arrive at a $10.6 million penalty. Alternatively it could deduct the cost of CNP, once known, from the $49.5 million figure to arrive at a penalty.

Pacific Bell also believes that TURN's penalty recommendation is inappropriate and excessive, since there is no indication of willful violation of the cease and desist order in

the matter of the "branded" directories and the 611 referral program. At most, these were minor incidents, causing no harm to Pacific Bell's ratepayers. Further, Pacific Bell acted swiftly and cooperatively to correct these problems once they surfaced. In sum, TURN's penalty recommendation is an excessive doubling of the penalty due to unintentional activities of Pacific Bell.

Pacific Bell submits that TURN's CATF proposal is unnecessary for several reasons, including the existence of Commission investigatory resources and intervenor compensation rules.

Pacific Bell considers Public Advocates' refund calculations to be overstated and inaccurate, and urges the Commission to remember that Public Advocates has undertaken an advocacy analysis rather than a straightforward statistical analysis. According to Pacific Bell "Exhibit 725A is a purely factual document that does not contain a single extrapolation of its findings to Pacific Bell's entire customer base, either for numbers of customers, or for dollars of refunds." (Pacific Bell reply brief, p. 256.)

In addition, Pacific Bell opposes imposition of a 75% goal for Universal Lifeline Telephone Service (ULTS), arguing that no record exists for such a quota system and no argument has been presented as to why such a quota proposal should be adopted by the Commission. Pacific Bell does not believe that it was ever required to, nor did the Commission or the Legislature ever intend that Pacific Bell, actively seek out and sign people up for ULTS, regardless of the customer's wishes. Pacific Bell <u>does</u> feel that it should do all it reasonably can to make customers aware of the availability of ULTS, and Pacific Bell promises that it is undertaking enhanced efforts to do so. As an example of these efforts, Pacific Bell reminds the Commission that it has recently mailed several ULTS bill inserts informing customers of the availability of, and eligibility requirements for, ULTS, and urging

them to subscribe to the service. Recent statistics indicate that Pacific Bell's ULTS subscribership has increased 80% since January 1, 1986 and ULTS subscriptions have increased 32% since January 1, 1987. These results indicate that customers are applying for ULTS at a tremendous rate, first because of significant changes in the economic criteria for qualification, second because of the measured rate changes and allowances, and third because of the introduction of a flat-rate ULTS offering in measured rate exchanges. As a result of the success of these efforts, Pacific Bell believes it would be completely inappropriate to order a quota system.

Similarly, Pacific Bell opposes the "educate the ratepayer" penalty for a variety of reasons. First, it notes that this recommendation was not raised on the record, and that there is no record on how to devise this penalty. Second, such a penalty is not necessary. This is not a Levi Strauss situation, where customers are not identifiable and locatable. It also maintains that 25 cents a month is not a trivial reduction. It believes other watchdog groups exist, and there is no need to create a new one. Finally, in addition to being vague, Public Advocates' proposal would require a good deal of oversight, and for that reason, is not desirable.

Given the fact that Public Advocates has provided no meaningful detail about its proposal, Pacific Bell wishes to go on the record as stating that if a further penalty is imposed (which Pacific Bell opposes), it should take the form of a revenue requirement reduction.

Along with the other parties in the proceeding, Pacific Bell believes that the workshops should continue, since they have been extremely beneficial. It agrees with TURN's recommendation that the Commission should clarify in this order that the CNP/workshops mechanism is to continue until terminated by Commission order.

In its reply brief, Pacific Bell indicates that it plans to trial other notification procedures. Pacific Bell terms this a Customer Communications Trial (CCT) designed to determine what additional measures are appropriate to better communicate with customers who may not have understood or even read the original notification materials. The purpose of the CCT would be to test a statistically valid sample of the remaining residential customers who have custom calling/COMMSTAR service and who have not previously requested a refund. The trial will be designed to determine what percentage of customers who did not respond to the CNP would do so now. The CCT will test and measure the difference in response between telephone contacts versus mail contacts. The results of the CCT will indicate which type of notification will be justified on a cost/benefit basis. Based on the results, Pacific Bell will implement some further customer notification and/or refund effort. Pacific Bell indicates that workshop participants have concurred in the trial concept and are reviewing the materials to be used with this further notification program.

Finally, Pacific Bell believes that the workshops have proven to be such an effective tool that the CMOC, the Customer Marketing Oversight Committee, envisioned by the Commission in the cease and desist order, is no longer necessary.

5. <u>Summary of Penalty Recommendations</u>

The penalty recommendations of the parties have been summarized in the briefs as follows:

Pacific Bell	DRA	TURN	Public Advocates
No penalty is warranted. Pacific has already spent $39 million implementing the CNP. It is also expending additional efforts to broaden its notification and refund process.	Pacific should conduct another refund program, then the Commission can decide whether a penalty of $49.5 million, $16.5 million, or some other amount should be imposed.	Pacific should be penalized $49.5 million for initial problems, plus an additional $51.5 million for directory and repair issues. Pacific should also implement another CNP.	Pacific should conduct a "massive" refund and extensive Lifeline campaign aimed at minority and low income customers. Pacific should also pay a "specific" penalty of between $7.5 to $15 million.

D. <u>Discussion</u>

Our early efforts to address the marketing abuse problem were of a restitutionary nature. We ordered Pacific Bell to implement the CNP, to make the required refunds, and assign these costs to its shareholders. Our goal was to make innocent ratepayers whole, while shielding them from the associated costs. As we stated in D.86-08-026:

> "It is fundamentally clear that were it not for the violations of statute, general order, and tariff provisions cited in D.85-06-072, none of the costs and expenses to be incurred as a result of today's order, and required to implement the notice and refund program, would have been incurred. Simply stated, there is no reason to require that any of the costs of the remedial notice and refund program be borne by ratepayers who did not cause the cost of the

> program, and who will receive no additional benefits from the program, but will merely be restored to the position they would have enjoyed but for these marketing abuses. For this reason, separate and apart from any 'penalty' overtones, these costs should be borne by shareholders." (D.86-08-026, mimeo. pp. 19 to 20.)

We also ordered Pacific Bell to track costs, expenses, and overheads associated with the program under a method ensuring that such costs and overheads are accorded below the line treatment, consistent with the determination that program costs be borne by shareholders. We also ordered segregated tracking of extraordinary expense and revenue impacts associated with the program to ensure that these impacts would not affect test-year estimates and projections in future rate proceedings. It should be abundantly clear that while these orders adversely impacted shareholders by requiring them to bear the costs of these programs, we believe that was the appropriate result, designed to address the ratepayer harm and to place the problem at the doorstep of those whose policies and/or inattention had caused the problem in the first instance. Pacific Bell's management was responsible for these policies, and is accountable to shareholders for any costs associated with the downside of those policies.[7]

We do not view this restitutionary remedy as a penalty, and thus we obviously disagree with Pacific Bell's attempt to

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7 We believe Pacific Bell has painted an overly bleak picture in any event. It is indeed somewhat likely that the costs of CNP will result in a "plus" for Pacific Bell, since CNP was an unprecedented multilingual outreach effort. As a result, Pacific Bill has gleaned much valuable marketing information, which may redound to the future benefit of its shareholders. The sensitivity of this information, and its future value, was one reason Pacific Bell made a belated (and unsuccessful) effort to have the tracking data received in evidence under seal on "proprietary" grounds.

characterize it as such. The CNP and associated costs are merely designed to restore the status quo prior to these problems, and to protect the interest of those who were innocent victims. Therefore, we will review the penalty issue as a separate question, given the desire not to muddle the two concepts.

There is still much to accomplish in the restitutionary area. It is abundantly clear that the consensus of all parties supports the continuation of the workshop mechanism, as well as a second notification campaign.

Given the findings presented in the tracking reports following the initial CNP, we believe that it is undisputed that that initial program has not yet achieved adequate levels of notification, rectification, and refund. It is desirable therefore for Pacific Bell to develop and test further informational and corrective measures, in concurrence with the workshop participants, and without the requirement of prior confirmation by the ALJ or this Commission. Indeed, it appears that Pacific Bell's CCT program is a first step in the right direction. Within 30 days from the effective date of today's order, we would expect Pacific Bell to be prepared, given the lapse of time between submission of briefs and the date of this decision, to provide the workshop participants with some results of the CCT and to meet with those participants to develop a further plan for notification. We do not see a need for further Commission involvement in this effort, except that we will require Pacific Bell to file and serve a compliance filing in this docket briefly detailing the mechanism to be used in this further notification campaign before it is actually launched. If the participants are not able to agree on a format and/or the substance of the plan, they may raise this issue more formally in this docket.

The further notification measures that are part of this second notification effort should link the new itemized billing format to the continuing availability of refunds under guidelines

already developed for the CNP. For this reason we see some merit in Public Advocates' arguments about a "red circle" campaign similar to that conducted in the IWM matter and we would like to see something patterned after that model. However, we will not direct the institution of such a campaign at this juncture, preferring to allow the workshop participants to develop a suitable plan based on the results of the CCT.

Pacific Bell is under a continuing obligation to conduct notification and refund programs at shareholder cost, in order to attempt to reach all affected customers. The CNP/workshop mechanism which has been so successful in the estimation of all parties will continue in effect until terminated by this Commission. In our order today we will provide for a time line for an eventual joint filing by the workshop participants requesting termination of the mechanism once the remedial goals have been met.

The abuses associated with lifeline service require a slightly different treatment. It is obvious from the tracking data that CNP was not really successful in remedying this abuse. We do believe that Pacific Bell has made some constructive efforts to increase subscription to lifeline service. And, we do agree with Pacific Bell that the appropriate goal, rather than some quota such as the 75% suggested by Public Advocates, is to make sure that sufficient information is available to customers who are eligible for lifeline service, that they are able to make intelligent choices about whether to subscribe to that service. Implicit in this determination is the notion that Pacific Bell of course will properly apply General Order 153, and make lifeline service available to those customers who are indeed eligible.

We indicated in D.86-08-026 that once we formed the CMOC we would include on its agenda a review of the operational effectiveness of Pacific Bell's new contract sequence guide for implementing General Order 153. We believe that the CMOC should be used as well to monitor Pacific Bell's new lifeline campaign in

connection with its overall review of whether Pacific Bell's program is adequately tracking the General Order. As we indicated in the cease and desist order, the purpose of the CMOC is to ensure that Pacific Bell's customer marketing practices, for both the residential and business sectors, are brought into conformance with the statutes, orders, and appropriate tariffs on file with this Commission, and that appropriate safeguards are put in place by Pacific Bell's management to ensure such conformance in the future. In compliance with our directive in the cease and desist order, the CACD Division submitted a workshop report on July 25, 1986 outlining how the CMOC would operate. That report is attached to this decision as Appendix C, and is more thoroughly discussed subsequently. For now, we indicate that one primary responsibility of the CMOC will be to monitor Pacific Bell's new lifeline campaign and assess its effectiveness.

We have attempted to distinguish between "make whole" remedies and other remedies designed to deter future abusive conduct or to send some sort of message to other utilities. The problem with the "make whole" efforts undertaken today is that such remedies do not succeed in reaching everyone. That has certainly been demonstrated by the tracking data presented. Nonetheless, we should do the best we can to attempt to reach every ratepayer who can be reached, and that is the basis of our decision to authorize the new refund campaign Pacific Bell wishes to undertake. There remains however, the question of what to do about the fact that not everyone has been reached and not everyone can be reached. The recommendations for general penalties, including those of DRA and TURN, do not adequately address the limitations of a restitution program. They do not effectively target ratepayers who have actually been harmed, and in some cases may benefit customers who have already received refunds or have suffered no harm at all. DRA's recommendation (which contrary to Pacific Bell's arguments, does reflect a mitigation factor) suffers from the principal defect

of being too general since it is not targeted to address those who have suffered the most harm. TURN's recommendation, that we use the DRA base amount and triple it, but target residential customers, suffers from the same defect. In addition, we do not believe that TURN has successfully proven that the penalty should be augmented in a somewhat arbitrary fashion by $50 million based on the "branded" directory and 611 referral incidents. We believe the record is clear that these were isolated instances, more reflective of the inability of a large organization such as Pacific Bell to achieve a perfect result. The important thing is that once the abuses were identified they were corrected promptly, responsibly, and apparently fully. Therefore, we will deny TURN's motion that we find Pacific Bell in contempt of the cease and desist order.

TURN's suggested CATF is essentially a request for a limited program of "up front" funding of advocate fees; we have an existing intervenor funding program, which may be far from perfect in some respects, but which we are committed to making successful. We see no need at this juncture to create CATF. Additionally, we have developed a remedy, discussed infra, which we view as superior to CATF in addressing the needs of ratepayers in the current telecommunications marketplace.

Likewise, (and recognizing that Pacific Bell naturally opposes any penalty in addition to the restitutionary remedies already ordered) we reject the utility's suggestion that we deduct the costs of the restitutionary remedy from DRA's $49.5 million base penalty, to arrive at a differential figure. This again confuses the differing goals of restitutionary remedies and penalties. In addition, the suggestion is not targeted to address the problem at hand.

Of all the options presented to us, we believe that Public Advocates has come the closest to recommending a specific penalty designed to address the fact that the restitutionary remedy

will not reach all affected ratepayers. Over and above the restitutionary remedies already ordered, we have decided to impose on Pacific Bell a limited purpose penalty. This penalty will be designed specifically to fund a ratepayer education program aimed primarily at ensuring that marketing abuses do not occur again as the marketing of monopoly services by the utility becomes increasingly enmeshed with the provision of more competitive enhanced telecommunications services. The limited penalty we choose is forward-looking and is designed to be a constructive remedy. We believe that Pacific Bell has been chastened enough. We also believe it has been making serious attempts to improve its marketing practices. It is important to get this matter behind us, and we would rather put protections in place and move on to the future. For that reason, we decline to adopt the recommendations of the other parties that we wait until the second CNP process is complete before addressing this penalty issue.

We will impose an education-oriented penalty of a specific nature totaling $16.5 million. This amount is chosen to recognize the correctness of DRA's focus on annual marketing salaries in calculating its base penalty amount. Within 30 days of today's order, we will order Pacific Bell to charge an appropriate non-operational expense account[8] in the amount of $16.5 million and set that amount aside in a special interest-bearing account, pending establishment of a trust to further ratepayer educational efforts. We do not intend to define "ratepayer educational efforts" in any rigid sense; however, the funds set aside should be used broadly to promote ratepayer education and understanding of the telecommunications system, and to educate ratepayers about

8 It is our intent that Pacific Bell's shareholders fund the ratepayer education trust established pursuant to this order.

their service options in the increasingly competitive telecommunications environment. Such efforts might include, but not be limited to, mass media programs, educational forums, community outreach efforts, or grants to selected groups. The goal of this trust should always be ratepayer education, keeping in mind the genesis of the fund. The Trust will include a disbursements committee, whose goal should be to disburse $3 million per year out of this fund to promote ratepayer education efforts, over the next five years. We will require that the financial trustee file annual accountings at the end of each calendar year with our Executive Director indicating (1) the amounts disbursed during the preceeding calendar year, (2) the identity of those receiving such disbursements, and (3) account or trust balances as of the same period. If a problem appears, we will naturally expect our Executive Director to inform us so that we can take appropriate action.

In its comments to the ALJ's Proposed Decision, Pacific Bell suggested that the proper way to proceed is to establish a legal trust, much like the Deaf Equipment Acquisition Fund (D.E.A.F.) trust, separate and apart from the utility's books of account. Pacific Bell proposes that CACD review and approve the terms and conditions of the trust prior to its original establishment. The $16.5 million would then be paid directly into the legal trust.

In its comments, TURN has suggested safeguards to avoid conflict of interest concerns and to ensure that activities funded by the trust do not duplicate customer information activities already envisioned in our Phase 1 decision. TURN also believes parties should be given a choice whether to join the disbursements committee.

We believe the Proposed Decision clearly provides that Pacific Bell shall not benefit from the trust or further its marketing goals or other corporate profit motives by virtue of the

trust. We take the following further action in this order to ensure that these provisions are carried out, and to address the concerns raised in the Comments.

First, we wish to establish a legal trust, separate and apart from Pacific Bell's books of account.

Second, we will require Pacific Bell to draft the trust instrument and submit the draft to CACD for review. CACD shall then prepare a resolution for our consideration which details these terms and conditions, and addresses all matters necessary for establishment of the trust, including the identity of the financial trustee and disbursements committee membership. Pacific Bell will then pay the $16.5 million previously set aside in response to this order, plus any accrued interest, into the legal trust.

Third, it is our intent that this trust conform to IRC § 501(c), and we will require Pacific Bell to take all steps necessary to effect this intention.

Fourth, we will ask the Public Advisor to work with Pacific Bell and DRA to solicit requests from consumer groups which may wish to serve on the trust's disbursements committee.

It is our intention to retain the disbursements committee structure set forth in the ALJ's Proposed Decision, with DRA, Pacific Bell, and two consumer groups serving as committee members, and the Public Advisor serving in the mediation/tie-breaking voting capacity envisioned by the ALJ. Because we have stated that disbursements committee members (and by implication, their clients) cannot have access to the funds to be disbursed, TURN and Public Advocates, the ALJ's original committee choices, have indicated in their comments that they do not wish to serve on the committee under such circumstances. Thus we will seek the involvement of two other consumer groups.

Based on his efforts with Pacific Bell and DRA, the Public Advisor shall make recommendations to us as soon as

reasonably possible, and obviously prior to establishment of the trust, for these two replacements based on the following criteria:

1. The group(s) must have experience with mass consumer education programs;

2. The group(s) must not have appeared before the Commission in its formal proceedings.

3. The group(s) must have a proven track record representing consumers in California.

4. The group(s) must be willing to forego competing for trust monies, as a condition to serving on the disbursements committee.

Fifth, we believe we have adequately addressed conflict of interest concerns. Nonetheless, we are adamant that trust monies not be spent on programs or proposals which duplicate programs covered by authorized commercial expenses. We believe DRA's participation on the disbursements committee will help to ensure that such duplication does not occur, since DRA is thoroughly familiar with the commercial expense area litigated in Phase 1.

Sixth, in all other respects, the proposal outlined in the ALJ's draft decision will be affirmed, and should be used as the guidepost for carrying out our more explicit instructons detailed above. We recognize that the precise dates (March 1988 and annually thereafter) for disbursements committee meetings will slip due to delays in implementaton associated with the new provisions in today's order, but CACD can present a new meeting timetable at the time it presents its resolution to us.

In all other respects the conflict of interest protectons and voting provisions set forth in the ALJ's Proposed Decision will apply, as discussed below.

To establish a program of disbursements for each year, the disbursements committee shall meet to discuss proposals for that year's spending levels. The proposals need not emanate from

Pacific Bell alone, and the other three disbursement committee members are also free to present proposals for consideration during the annual meeting. Based on the decision of the four-member disbursements committee (with each member having one vote), the trustee shall proceed with disbursements. In no event shall such disbursements benefit any of the four disbursements committee members. If the committee is unable to make a decision on a particular disbursement, or its members are otherwise deadlocked, the Commission's Public Advisor shall seek to mediate the dispute with the authority to cast a vote if necessary. The Public Advisor is chosen for this role, because of the broad experience of that office with ratepayer concerns which should give the Public Advisor a special insight into ratepayer educational efforts.

At the end of five calendar years of disbursements, the trustee shall disburse the balance in the trust fund remaining in year six, on the same basis as the preceding five calendar years.

We have decided to proceed despite the fact that Public Advocate's "educate the ratepayer" penalty proposal was not really detailed in the briefing stage, because we feel the approach that we are implementing has several benefits. First, it is relatively straightforward. The $16.5 million amount is equivalent dollarwise to the DRA base penalty amount which is keyed to marketing salaries and overheads. It is also close to Public Advocate's recommendation premised on a $2 per residential ratepayer figure.

Second, the penalty funding proposal is targeted. The record clearly indicates that improved educational efforts and an informed ratepayer public are necessary, in conjunction with other remedial steps taken internally by Pacific Bell, to prevent recurrence of this type of situation.

Third, the mechanism is relatively simple and does not require extensive oversight or administration by this Commission itself. The goal of "educating the ratepayer" is a

straightforward, albeit broadly defined goal, since we do not wish to make this fund unduly difficult or complex to administer.

Fourth, the goal intended to be achieved by creation of this fund is a positive one, which is future oriented.

Fifth, the disbursement mechanism ensures the involvement of those parties who are most keenly aware of the problem and who have been closely involved in developing solutions, while at the same time protecting against the promotion of self interest by these same parties.

Sixth, requiring annual reports to the Commission's Executive Director, ensures a degree of oversight by this Commission which is minimally necessary to keep the Commission informed of the status of the fund and to alert the Commission to the necessity of acting should problems appear.

We recognize that this particular mechanism was not detailed on the record, but we believe it is within our discretion to develop remedies which are designed to rectify problems which are apparent on the record. We have solicited comments from the parties in an attempt to refine the trust mechanism, and we are satisfied that we have provided the guidelines necessary to proceed.

E. Ancillary Issues

1. The Customer Marketing Oversight Committee

It is necessary in this decision to clarify the status of the CMOC, previously discussed in connection with the cease and desist order. The charter developed by the CACD Division and the workshop participants is attached to this decision as Appendix C as previously noted. Therefore, we will not go into any detail in describing the committee, since we expect it will operate in accordance with the proposed charter and we will so order. However, it is necessary to clarify certain points. First, we agree with the workshop participants who developed this charter that the following issues should be addressed by the Committee

pursuant to its overall mandate to "ensure that Pacific Bell's customer marketing practices, for both business and residential sectors, are brought into conformance with the statutes, orders, and other appropriate tariffs on file with this Commission" and that appropriate safeguards are put in place for the future. (D.86-05-072, mimeo. p. 16.)

a. Business and residence incentive plans for salaried and non-salaried employees;

b. Business and residence quota plans (or similar plans, e.g., goals, objectives, targets, etc.) for both salaried and non-salaried employees;

c. Trial offerings of services;

d. Renaming and packaging of services;

e. Administration of deposit practices;

f. Administration of Universal Lifeline Service;

g. Incentive, quota, or similar plans in other Pacific Bell organizational entities;

h. "Cold selling" or other telemarketing activities.

While we hope CMOC will be able to address all of these issues, we have placed special emphasis in our prior discussion on the question of Universal Lifeline Service. We believe it is crucial that the committee carefully look at the manner in which Pacific Bell is administering that service and ensure that, as the charter states, Pacific Bell's marketing practices are brought into conformance with General Order 153 and that appropriate safeguards are put in place by Pacific Bell's management to ensure such conformance in the future. We do not expect the CMOC, however, to become embroiled in a controversy over goals or other types of quotas as recommended by Public Advocates for lifeline service. Rather, we believe the CMOC should review Pacific Bell's current

(and heightened) outreach efforts, and satisfy itself that these efforts are appropriate and consistent with the relevant statutes, orders, and effective tariffs on file with this Commission.

In addition, as we directed in the cease and desist order, Pacific Bell has been ordered to cease any cold selling or telemarketing activities and to discontinue its sales quota programs until further order of this Commission following review of these practices by the CMOC. We would expect that any recommendation made by the CMOC at the end of its term would address the question whether this ordering paragraph should be modified, and if so, how. Thus we do not consider the arguments presented by Public Advocates in its comments on "outbound calling." Nor do we consider Pacific Bell's comments on the telemarketing issue (Comments to ALJ's Proposed Decision, p. 3).

We expect the CMOC chairperson to keep us informed via compliance filing, of crucial events, as a matter of judgment. We do provide in today's order for a final report from the chairperson at the conclusion of CMOC's term.

Finally, Article VI of CMOC's proposed charter, dealing with the term of the committee, should be modified to indicate that unless otherwise ordered, the committee shall be dismissed no later than May 30, 1989. This change is necessary since the sunset provision provided in the original proposed charter was December 31, 1987, and that date is now unrealistic. A 17-month term for the CMOC is consistent with that originally envisioned in the proposed charter, and that is why the May 30, 1989 date has been chosen.

In all other respects, the proposed charter should be adopted in final form, to be followed by the CMOC over the period of its existence.

A final note is in order. Although we recognize the fact that the CMOC represents an intrusion into matters that would ordinarily be left with Pacific Bell's marketing management, the

record amply demonstrates the necessity for the slight intrusion we order. Our goal here is to satisfy ourselves that protections are in place that will ensure, in an internal sense, that the same types of abuses do not occur again. However, it is important to note, as the workshop participants who developed the proposed charter have recommended, that this CMOC is only a temporary advisory body to the Commission and should be dissolved no later than May 30, 1989. We agree with the observation made by the workshop participants, who strongly believe that the CMOC should not be a surrogate for Pacific Bell management or the Commission staff.

2. Tariff Rule 12

DRA's Shantz has suggested revisions to Tariff Rule 12 which covers optional rates and information to be provided the public. This was one of the rules Pacific Bell was found to have violated in the cease and desist order. DRA is recommending that the Commission order Pacific Bell to modify its current Rule 12 within 60 days of the effective date of any order adopting DRA's proposed revisions. These proposed revisions are designed to make Tariff Rule 12 very specific in dealing with the types of situations which led to customers being sold services they had not ordered. The revisions provide for the following:

a. Full disclosure of available residence exchange access services and the associated tariffed rates and charges.

b. Full explanation of residence optional services requested by the customer and a quotation of the associated tariffed rates and charges.

c. Full itemization of business services requested by the customer at the time of taking orders for such services along with a quotation of the associated tariffed rates and charges.

d. Confirmation letters to be sent to residence and business customers who place

> orders for service or revisions to existing service providing the customers with a brief description of the services ordered and the associated tariffed rates and charges. (Exhibit 589, p. DMS-6.)

Pacific Bell's position is that these modifications are unnecessary because Pacific Bell's current methods and procedures fully comply with Rule 12 in its current form. Nonetheless it has offered to work with interested parties to reach agreement on Rule 12 wording and intent issues (Exhibit 720, p. 15). However, we believe, given our experience in this matter, that the more cautious approach is to make the tariff explicit as DRA's Shantz requests. Therefore, we will order Pacific Bell to implement the proposed tariff Rule 12 revisions contained in Appendix C to Shantz' Exhibit 589, within 60 days of the effective date of today's order. (For ease of reference, these revisions are attached to this order as Appendix D.) We think that 60 days is a reasonable timeframe to allow for implementation. However, in order to ensure that the matter is resolved within 60 days, we will require Pacific Bell to file an Advice Letter within 30 days of today's order which contains the revisions suggested by Shantz.

DRA has also recommended that we adopt these same proposed tariff revisions for the other local exchange telephone utilities subject to our regulation in order to mitigate the possibility that any of these other utilities might engage in similar abusive marketing practices. DRA also believes that its suggested revisions to Rule No. 9, in the area of detailed billing, may cause some major changes to be made to the billing systems of other local exchange telephone companies and therefore DRA recommends provision of a six-month implementation interval. At this time, we are not prepared to implement such changes for the other local exchange telephone utilities, who were not actively involved in litigating the marketing abuse issue, and who have not taken the opportunity to address DRA's recommendations.

It should be noted again, that in Resolution T-12001, dated February 11, 1987, we ordered Pacific Bell to provide itemized billing for its residential customers effective March 1, 1987, and to report to CACD no later than April 1, 1987 its plans to provide itemized billing for business customers. At present, CACD and Pacific Bell are in the process of developing a prototype itemized billing format for business customers which will provide for an annual itemization, or, alternatively more frequent itemization at the customer's request. We expect itemized billing for business customers to be in place in January or February of 1989, and will require an advice letter filing from Pacific Bell no later than December 31, 1988, to accomplish this goal.

3. Public Advocates' Eligibility for Compensation

On March 11, 1986, Public Advocates filed a Request for a Finding of Eligibility for Compensation in connection with the marketing abuse question. No other party has filed a formal response to Public Advocates' request. The request was timely filed within 45 days after the close of the evidentiary record. (Rule 76.45(a).)

Public Advocates represents the League of Latin American Citizens (LULAC) and Chinese For Affirmative Action (CAA) in the marketing issue.

In D.86-01-006, we stated that Public Advocates as representative of six interested party organizations,[9] was eligible for compensation as a public participant in this proceeding. At that time, Public Advocates' participation in the Pacific Bell rate case was limited to the issue of FMBE questions. D.86-01-006, was issued subsequent to two other eligibility orders

9 One of these clients was LULAC, who as mentioned previously, is represented by Public Advocates in the marketing abuse question as well.

involving TURN (D.85-06-028) and CPIL (D.85-07-023), which found those two interested parties "eligible" to claim compensation for their participation in this proceeding. In the case of TURN, we explicitly recognized that the proceeding would extend beyond 1985, and intended our determination to last for the duration of the proceeding (D.85-06-028, Ordering Paragraph 1). In the case of the decisions addressing CPIL and Public Advocates, we merely stated that those parties were eligible "in this proceeding."

Subsequent to these TURN and CPIL eligibility determinations, we refined our analysis of the requisites of the eligibility filing. Essentially, we realized that these earlier decisions had equated "eligibility" with meeting the significant financial hardship test, whereas the eligibility determination requires analysis of three other factors as well. Strictly speaking, it is only the significant financial hardship determination that carries over on a calendar year basis (Rule 76.54(a)(1)). Therefore, in D.85-11-057 we clarified that the annual calendar year determination (which the preceeding decisions in the Pacific Bell case had liberalized for the benefit of interested parties who would be involved in the case over a number of years) relates only to the "significant financial hardship" component of the eligibility finding. However, three other provisions of Rule 76.54(a) requiring specification of the issues to be raised, estimates of compensation to be sought, and budget for the proceeding, must be addressed in every other proceeding where eligibility is sought during that calendar year. The requirement that these issues be addressed is designed to provide us with some notion of the extent of the intervenor's participation in a particular proceeding and to allow us to address the common legal representative issue, if appropriate (Rules 76.54(c), 76.55, and 76.59). This interpretation was carried through in the recent AT&T-C Communications (AT&T-C) rate case decision, where Public Advocates was found to have satisfied (on behalf of the customers

it was representing in that proceeding) the "significant financial hardship" test for calendar year 1986, with the caveat that it was still required to address the additional three requisites in other proceedings where it sought eligibility findings during that same calendar year (D.86-11-079, mimeo. p. 171).

Therefore, there has been some modification of our approach subsequent to the issuance of the initial eligibility decisions in this docket. The most reasonable approach to take at this juncture is to give effect to our original intent in D.86-01-006 and not require Public Advocates to again address on behalf of LULAC the significant financial hardship test in this protracted proceeding.[10] However, since Public Advocates has broadened its participation beyond F/MBE issues, we will require Public Advocates to address Rule 76.54(a)(2) through (4), due to the nature of its increased involvement in the proceeding. This will enable us to assess its eligibility for compensation

10 We fully recognize that CAA is in a slightly different position than LULAC, in that it was not one of the Public Advocates clients covered by our initial eligibility decision in this proceeding (D.86-01-006). Nonetheless, Public Advocates has been found to have satisfied the significant financial hardship test on behalf of CAA in calendar year 1986 in D.86-11-079, issued in the AT&T-C rate proceeding. This determination on behalf of CAA does not carry over to calendar year 1987. However, given our desire in D.86-01-006 to relieve Public Advocates of the burden of reestablishing significant financial hardship on behalf of its clients in this protracted proceeding every year, we will invoke Rule 87 of the Rules of Practice and Procedure, and consider CAA as well as LULAC to be covered (for this proceeding only) under D.86-01-001 for the duration of this proceeding.

associated with these new issues. This is a reasonable result given the manner in which the issue has unfolded.[11]

Rule 76.54(a)(2) requires a statement of issues that the customer intends to raise in the proceeding. Public Advocates indicates that the nonprofit organizations it represents intend to raise four issues relating to the marketing abuse question. First, they will raise the issue that substantial further information should be collected (such as the Field Research Study) before a final decision is rendered, in order to assess the magnitude of the impact of Pacific Bell's practices on low income and minority ratepayers. Second, they intend to argue that refunds were the fairest and most effective remedy for both unwanted optional items and for lifeline abuses. Third, they intend to make specific and unique suggestions in order to ensure that minorities and other customers are effectively informed of potential refunds. Fourth, they have argued that Pacific Bell should undertake comprehensive follow-up studies, such as the Elrick and Lavidge study, designed and actively pursued by Public Advocates.

Rule 76.54(a)(3) requires an estimate of the compensation that will be sought. Public Advocates intends to seek full compensation in each area set forth in the previous discussion. It estimates that it will seek compensation in the approximate amount of $115,500.

Rule 76.54(a)(4) requires a budget for the customers' presentation. Public Advocates presents its $115,500 budget as follows: Attorney/Advocate Fees (Gnaizda) $78,750; Junior Attorney Fees $4,250; Law Clerks/Clerk Fees $7,500; Law Student/Clerk

11 We do not mean to relieve Public Advocates of the requirement of meeting Rule 76(a)(1) for calendar year 1987 in other proceedings. The outcome specified in this decision is unique to the Pacific Bell general rate case docket (A.85-01-034) given our broad "eligibility" finding in D.86-01-006.

(Expert) Fees $6,500; Expert Fees $15,000; and other fees and expenses $3,500.

Based on the eligibility finding in D.86-01-006, and the supplemental information Public Advocates has now provided addressing the requisites of Rule 76.54(a)(2) through (4) relative to its participation in the marketing abuse issue, we find that Public Advocates is eligible for an award of compensation in this proceeding for its involvement in the marketing abuse question.

VI. Bilingual Telephone Issues

A. A Brief Procedural Background

This issue emerged late in the proceeding, after issuance of D.85-11-020 in the Commission's generic bilingual telephone proceeding (Case 9976). D.85-11-020 provided that shortcomings in bilingual operator or other similar services could be raised in either AT&T-C's or Pacific Bell's general rate cases. On May 6, 1986, Public Advocates filed a motion to set hearings on the adequacy of Pacific Bell's bilingual services, including the question whether Pacific Bell should be required to implement a bilingual settlement similar to that adopted in AT&T-C's general rate case (D.86-11-079 in A.85-11-029) as a condition for approval of any rate increase. On June 9, 1986, the ALJ granted Public Advocates' motion, while at the same time urging the active parties to negotiate a solution similar to that negotiated prior to scheduled hearings in AT&T-C's A.85-11-029.

Subsequently, U.S. English expressed interest in becoming an active party in the proceeding, as well. U.S. English is a national, nonprofit membership organization which serves as a center for consultation and cooperation on ways to defend English as the official language of the United States. It was a major proponent of the recent Proposition 63 which was passed by California voters in November 1986.

Public Advocates and Pacific Bell were unable to negotiate all outstanding issues prior to the date testimony was due; therefore, Pacific Bell presented testimony outlining its plan, which was heard, along with the testimony of five Public Advocates' witnesses and one U.S. English witness on October 8, 9, and 14, 1986.

The bilingual telephone services issue was briefed by all active parties (Pacific Bell, Public Advocates, DRA, and U.S. English).

B. Pacific Bell's Program

The program has two main components: The Language Assistance Plan and the Hispanic Market Plan.

The Language Assistance Center, located in southern California, houses operators who provide Spanish translation services for "0" operators, repair service, and special operator services (for example, number referral, calling card, and public phone refunds). This Plan also provides for bilingual directory assistance service. Eventually Pacific Bell intends to provide similar services to its Asian language speaking customers, to the extent that this is economically feasible.

The Hispanic Market Plan involves possible employment of one hundred bilingual service representatives on a statewide basis. Moreover, job aids and forms will be available in Spanish, and Pacific Bell is currently trialing a Universal Training Package. This market component also calls for assessment of Public Office services and customer needs, more involvement with local Hispanic business communities, and increasing the number of directories so that 50% will contain emergency and dialing instructions in Spanish.

C. Pacific Bell's Position

According to Pacific Bell, its bilingual plan, the details of which were presented by its witness Moulton in Exhibit 590, make it undeniably clear that Pacific Bell is committed to

providing high-quality bilingual services. It has decided to enhance these services because the economics of such an undertaking are promising. Pacific Bell cites opening statements by Public Advocates and DRA indicating support for the bilingual services plan, on the rationale that it will benefit all of Pacific Bell's customers, including the English speaking. Contrary to the statements made by U.S. English, which Pacific Bell believes are meritless, Pacific Bell believes it should be permitted to continue its plan without further interruption.

Pacific Bell argues that U.S. English's views are unsubstantiated, and are directly contradicted by statements of other witnesses who represent non-English-speaking customers. For example, Pacific Bell criticizes U. S. English witness Diamond's claim that the plan will create community divisions where none exist today. In each instance, Pacific Bell believes that Diamond is attempting to represent the impact of the plan on non-English-speaking customers, without having in any instance taken those views into account. In order to determine whether Diamond's allegations are correct, the utility submits the testimony of those parties who do represent the non-English-speaking customer must be analyzed. For example, Mr. Der, Executive Director of Chinese for Affirmative Action, emphatically disagreed with each Diamond's assertions, testifying that ". . . [N]ecessarily bilingual assistance or bilingual access is an important mechanism for [Chinese-speaking adults] to function equally and fully in the American society (TR. 14709). Furthermore, Der stated that bilingual telephone services encourage, rather than discourage, the use of English as the common language:

> "Once [the non-English speaking] participate through bilingual means, I think there are many social, political, and economic barriers that are struck down, and therefore enhance a greater integration of these individuals into American society." (TR. 14711.)

Furthermore, Pacific Bell posits that the estimated incremental capital investment costs of its bilingual plan, approximately $500,000, compare favorably with the plan's potential incremental revenue. Pacific Bell cites rough estimates of other parties that gross revenues from total billings to Hispanic customers range anywhere from $200 million to $500 million (TR. 14463; 14528 to 31). While it does not necessarily agree with such "optimistic" projections, Pacific Bell only intends to continue the plan to the extent that it is, and remains, cost- effective.

To that end, Pacific Bell asserts that the Commission does not need to order it to provide adequate bilingual services. First, Pacific Bell has an adequate profit incentive to maintain the plan. Second, the plan is more extensive than AT&T-C's plan, because of additional provisions of bilingual repair and directory assistance services. Further, the plan includes formation of a Bilingual Consumer Advisory Counsel (BCAC) whose sole responsibility will be to track the plan's implementation. Fourth, Pacific Bell believes the Commission already has adequate mechanisms in place to assess the quality of service Pacific Bell provides to all of its customers. Finally, other oversight mechanisms and processess are either already in existence, or are currently being developed, which will be in operation throughout the plan's implementation period. Therefore, Pacific Bell believes the Commission can confidently conclude that the plan will voluntarily be implemented in an appropriate manner, and that a Commission order is therefore unnecessary.

D. <u>Public Advocates' Position</u>

Representing the Hispanic/Asian Coalition in this proceeding, Public Advocates notes its longstanding history of involvement in bilingual issues at the Commission. It chronicles efforts made over a 17-year period to obtain cost-effective and comprehensive multilingual telephone services. It also credits Pacific Bell for now taking the position that such services are

necessary to meet a great unmet need, which can be satisfied at little or no cost, while generating potential additional revenues exceeding half a billion dollars per year, thus resulting in lower rates and better service for all ratepayers.

Public Advocates notes that the Asian and Hispanic population within California represents a huge and untapped market. The U.S. Census predicts that the total California population will be 24.1% Hispanic by 1990 and 32.3% by 2020 AD. Furthermore, the Census predicts that almost 40% of the southern California population will be Hispanic by 2010 (Exhibit 595, p. 4). Present levels of bilingual telephone service fail to effectively tap into this market, in Public Advocates' view.

Public Advocates presented the testimony of Henry Der, Maria Navarro, John Gamboa, Michael Phillips, and Lenz Meylan, in support of its arguments that multilingual phone service will profitably and efficiently tap into this huge unmet market.

In Public Advocates' view, it was only after a careful analysis that Pacific Bell decided to implement its current bilingual telephone program, and it did so on the basis of enlightened self-interest. According to Pacific Bell's witness Moulton:

> "...finally Pacific Bell put two and two together and figured out that by improving service through improved language capability, we could improve revenues and profits because of the size of the market." (TR. 14458.)

Public Advocates points out that Pacific Bell is implementing the bilingual services plan as a deliberate business decision:

> ". . . We reorganized our marketing organization in October of 1985. One of the applications of that organization was to achieve a greater customer focus than we had had in the past. And that organization began to think about the Hispanic market very early and began to look at the size of that marketplace and realized that there were large

> dollars coming from the Hispanic market into Pacific Bell and began to think about how could the size of those dollars be increased. At the same time, Pacific Bell is working on a new focus on improving customer service in general. And I think it became clear that Pacific Bell's service isn't very good if you can't communicate." (Moulton testimony, at TR. 14457-8.)

Public Advocates roundly criticizes U. S. English's efforts opposing of bilingual telephone service. Public Advocates believes that U. S. English's position is based on untested theory, rather than concrete evidence.

In its reply brief, Public Advocates took umbrage at Pacific Bell's wish to totally free itself of Commission scrutiny in this area. It asserts that Pacific Bell's unilateral desire to free of such scrutiny, despite the evidence developed in this record and its 17-year history of ignoring profitability, is of special concern to the Hispanic/Asian Coalition. Public Advocate urges the Commission to maintain scrutiny by taking the following steps:

1. The Commission should maintain jurisdiction for a three-year period, or until the next rate case, whichever occurs sooner.

2. Pacific Bell should be required to submit semi-annual reports to the Commission. These reports should contain a complete narrative of progress made, and problems encountered, relating to multilingual service; they should also contain specific statistics relating to the number of customers served, by language, geographic area, and type of service (such as repair, billing, and operating service). Such reports should also contain a copy of any recommendations made by the Pacific Bell Bilingual Consumer Advisory Council, and any additional information that the Commission staff deems reasonable.

3. The staff or any party should be able to submit data requests on an annual basis to Pacific Bell regarding the status of its bilingual and/or multilingual program.

4. The Commission staff should have the right to seek an audit as to the progress of the multilingual program, should it, for good cause, believe this is necessary.

E. <u>DRA's Position</u>

DRA supports adoption of the Pacific Bell plan. However, it urges the Commission not to abrogate its oversight role, as Pacific Bell requests. Therefore, it urges that the Commission adopt a semi-annual reporting requirement to collect data on progress and implementation problems.

F. <u>U.S. English's Position</u>

With the narrow exception of emergency services, U.S. English opposes the concept of parallel telephone systems in more than one language. If such parallel systems are created, it believes they should not be subsidized by English-speaking ratepayers. Based on its participation in this record, U.S. English has generally concluded that Pacific Bell does not intend to create such a parallel telephone system, that it will not generally subsidize bilingual telephone services (other than emergency services), that it made the decision to provide bilingual telephone service as a profit-oriented market decision, and that it will be evaluate this decision in the future to ensure that no unnecessary cross-subsidization is taking place.

U. S. English believes that the Commission should not order Pacific Bell to provide non-emergency services in languages other than English, but should monitor Pacific Bell's plans to ensure that the utility does not impose non-English-language-related costs on, or otherwise infringe, the rights of English-speaking ratepayers.

G. <u>Discussion</u>

We appreciate the public policy importance of the debates about the best means to achieve social integration, as well as about what form that integration might ultimately take. However, we need not reach those issues in order to conclude that the service goals we set for Pacific Bell and for other local exchange utilities that serve significant non-English speaking populations require an effective bilingual customer information effort.

We are committed to providing a fully useful telephone system to California residents. The evidence is clear that a substantial proportion of Californians require information in languages other than English to understand and fully utilize the services offered by Pacific Bell. In addition, the apparent cost-effectiveness of providing such information highlights the fact that reaching the broadest possible customer base is a good business practice for any firm. Rather than funding a "parallel" telephone system (as U.S. English fears), we wish to include as many customers as possible on one, integrated local exchange network.

We will approve the Language Assistance Plan and the Hispanic Marketing Plan as an indication of our approval of the general direction Pacific Bell is pursuing on the bilingual services front. There does not appear to be any controversy <u>now</u> among the parties active in this proceeding, since all agree that these programs should be approved. Even U. S. English has apparently dropped its opposition.

The only controversy remaining relates to Pacific Bell's statement that the Commission should retain no future oversight role. We disagree with this posture, given the long-standing involvement of this Commission in the issue, and given the number of ratepayers who will be affected by Pacific Bell's programs. Our experience with the marketing abuse problem, where it appears that non-English speaking ratepayers were victimized disproportionately,

confirms the importance of our continuing involvement at this point.

In addition to maintaining jurisdiction over this issue, we will adopt some of the reporting requirements suggested by DRA and Public Advocates. Specifically, we will require Pacific Bell to submit semiannual reports to our Evaluation and Compliance Division Director, with copies to all parties listed on the service list of this proceeding. Such reports will be submitted on June 30 and December 31 of each calendar year, until further order of this Commission. The first report will be due June 30, 1988.

Such reports shall contain (1) a complete narrative of progress made, and problems encountered for the six-month period relating to multilingual service; (2) specific statistics relating to the number of customers served by language, geographic area, and type of service, such as repair, billing, and operator services; and (3) a copy of any recommendations made by the Bilingual Consumer Advisory Council on multilingual services during the period in question.

We do not believe it is necessary to reconfirm our ability through our staff to discover and audit utility records pursuant to PU Code §§ 313, 314, 314.5, and other relevant statutes. Therefore there is no need to make this explicit as Public Advocates has requested. We also will not adopt the suggestion that other parties be allowed to submit data requests to Pacific Bell on an annual basis. We believe it is sufficient that we require Pacific Bell to serve copies of its semi-annual reports on these other parties. If these parties wish to pursue any items noted in the reports, they may of course approach Pacific Bell for additional information, and we are confident given the cooperative relationship that has developed over a 17-year period, that in most cases there will be no problem obtaining such additional data. However, if there _is_ a problem, and these interested parties wish

to have the Commission intercede, they may raise the question more formally.

VII. Procurement From Female- and Minority-Owned Business Enterprises (F/MBEs)

A. Background

Having previously determined that there is a nexus between our regulatory responsibility to ensure just and reasonable rates and the quality of programs undertaken by utilities in the conduct of their business, this Commission in D.84-06-111, in Pacific Bell's last general rate proceeding, imposed two requirements with respect to Pacific Bell's practices for contracting or entering agreements for the provision of goods and services by female- and minority-owned business enterprises (F/MBEs, sometimes also referred to as M/WBEs for minority/women business enterprises).

First, we required Pacific Bell to meet with authorized representatives of recognized minority groups, specifically including those groups represented by Public Advocates during the antecedent proceedings. Second, we directed Pacific Bell, after meeting with these representatives, to draft and submit in the present proceeding a tracking procedure for F/MBE activities for Commission approval. The tracking procedure has three component requirements: (a) that the F/MBE data be reported according to the ethnic classifications used by agencies of the State of California; (b) that Pacific Bell break out total contracts by these ethnic classifications for categories in which $5 million or more of business was done in a prior year; and (c) that Pacific Bell submit semi-annual reports of its F/MBE activity on March 1 and October 1 of each year, with the March report to cover activity from July 1 through December 31 of the prior year and the October report to cover activity for the January 1 through June 30 period. In addition to these specific orders, D.84-06-111 stated that

Pacific Bell "should establish F/MBE goals for year 1986 and include them as part of its 1986 general rate case filing."

On February 19, 1985 Pacific Bell made a filing reporting its tracking procedure in the present rate proceeding as directed by D.84-06-111. The report sets forth Pacific Bell's general F/MBE objectives, how its F/MBE program was organized, managed, and run in 1984, and how much business Pacific Bell did with minority and women vendors in 1984. It describes Pacific Bell's tracking procedures for F/MBE purchases by stating that "[m]ajor ordering categories aggregating $5 million or more have been grouped under three main areas. . . . In addition, we have further disaggregated these three main categories into thirty-seven sub-categories...." It also states that Pacific Bell held meetings with recognized minority groups as required by D.84-06-111 and "closely consider[ed]" the options proposed by those groups in formulating "a starting point for future female and minority program accomplishments." Further, the report also sets out 1986 goals, displayed as a percent of total procedurement purchases for each ethnic group and for females in each ethnic group as well as "non-minority" females.

The report says that total 1984 F/MBE purchases were $65.3 million or 3.08% of total procurement purchases, and sets the 1986 goal at $74 million, equating to 3.4%. It estimates 1986 F/MBE recurring costs at $1,200,500 and non-recurring costs at $183,790 and asks that it be allowed to recover these costs in its authorized rate base in this current rate proceeding. The report also asks that the Commission approve Pacific Bell's goals and reporting categories.

In March, 1985 Public Advocates filed a response challenging the adequacy of Pacific Bell's F/MBE procurement goals on behalf of the Minority Coalition, an organization comprised of four minority groups that Public Advocates represented in Pacific Bell's last rate proceeding plus three additional minority and

female organizations.[12] The response asked this Commission to find Pacific Bell's goals to be out of compliance and to deny 20% of Pacific Bell's proposed rate increase until, among other things, Pacific Bell "negotiates...substantial and significant minority and female contract goals".

In April, 1985 Pacific Bell filed a supplemental report on its procurement goals which stated that Pacific Bell had discovered "certain computational and data base errors" in its originally filed goals. This report revised those figures, stating that Pacific Bell had made $97.9 million (rather than $65.3 million) in F/MBE purchases in 1984, totalling 3.19% (rather than 3.08%) of total procurement purchases, and that its goal for 1986 was $128.5 million (rather than $74 million) or 4.19% (rather than 3.4%) of total purchases. Pacific Bell claims this shows a 31.3% dollar increase from 1984 to 1986. There is no change in estimated costs of the program which Pacific Bell asks this Commission to adopt for test year 1986.

Five days of hearings were held on the F/MBE issue from December 16 through December 20, 1985. Pacific Bell presented one witness. The Minority Coalition presented eight witnesses, including the subpoenaed president of Pacific Bell. DRA presented one witness.

B. Positions of the Parties

The three active parties each submitted concurrent post-hearing opening and reply briefs on the F/MBE issue. Pacific Bell's briefs claim that Pacific Bell's F/MBE program is sound, has

12 The former group includes the Sacramento Urban League, the United States Black Chamber of Commerce, the League of United Latin American Citizens, and the American G.I. Forum. The latter group includes the Spanish Speaking Unity Council, Coalition of 100 Black Women of Northern California, and the Filipino American Political Association.

experienced substantial growth, and is undertaking to continue this trend without the need for additional Commission direction. Further, Pacific Bell supports the recommendations of its witness, Mr. Cannon, that:

1. The Commission allow Pacific Bell time, without additional regulation, to put into effect the steps it plans to take to raise its F/MBE spending levels;

2. The Commission accept a two-tiered reporting arrangement that separates Pacific Bell's high technology categories from all other categories and not require goals in these high technology categories, nor include them in program evaluation;

3. The Commission evaluate each utility company on the merits of its program;

4. The major utilities work jointly on the certification problem;

5. Pacific Bell be required to file F/MBE reports on an annual basis rather than semi-annually; and

6. Pacific Bell be allowed to recapture all its 1986 F/MBE program expenses.

Minority Coalition's briefs argue that this Commission should require Pacific Bell "to set goals and make progress, or else be denied its requested rate increase." Minority Coalition claims that Pacific Bell has demonstrated a lack of commitment to increasing F/MBE contracts, and has kept inadequate and inaccurate records of its F/MBE program. In order to make Pacific Bell's program reasonable and consistent with this Commission's prior directives Minority Coalition requests that we require the following:

1. Pacific Bell should set as a goal a forty percent per annum increase in contracts to M/WBEs, for each of the next five years, using as a base its figures from the end of 1985.

2. Pacific Bell should meet regularly with [Coalition] so that its progress toward this goal can be jointly monitored.

3. Depending on the extent of its progress toward the forty percent per annum goal, Pacific Bell may be required to submit an additional five-year plan in 1989.

4. Pacific Bell should develop a reliable, independent verification mechanism, acceptable to Public Advocates and CPUC staff, to remedy its problems with fraudulent M/WBE reporting." (Footnotes omitted.)

DRA's briefs recommend that Pacific Bell's proposed F/MBE budget for recurring and nonrecurring costs, now reduced from $1,384,290 to $1,068,500, be adopted for test year 1986, but that absent prior Commission approval costs of future voluntary expansion be borne by shareholders. DRA also contends that annual reporting, as we required of Southern California Edison Company and Southern California Gas Company, is sufficient. DRA states that Pacific Bell's new program goals and expanded operations will probably result in a significant decline in cost-effectiveness in the short run, but that DRA expects it to increase "as greater numbers of goods and services are purchased from F/MBEs". Nonetheless, DRA expresses some doubt as to the substantive accomplishments of Pacific Bell's present program and suggests that this Commission's "goals for increasing F/MBE participation in utility business...could be reached more expeditiously through the adoption of various recommendations presented by the witnesses sponsored by Public Advocates." DRA then "strongly recommends" that we "carefully scrutinize" Minority Coalition recommendations, but it specifies only the recommendation that we establish numerical goals for each reporting category.

C. Passage of AB 3678

Both Minority Coalition and Pacific Bell have requested that we take official notice of the fact that minority/female business procurement legislation (AB 3678) was signed into law by the Governor subsequent to these hearings on September 30, 1986. (Chap. 1259. 1986 Stats.) We hereby do so.

Briefly, AB 3678, which, as of January 1, 1987, affects every electric, gas, and telephone corporation with gross annual revenues exceeding $25 million (e.g. Pacific Bell) and their Commission-regulated subsidiaries and affiliates, requires the following actions:

1. It mandates the Commission to require each utility subject to the legislation to submit annually, a detailed and verifiable plan for increasing women and minority business enterprise procurement; these annual plans must include short- and long-term goals and timetables (but not quotas) and must include methods for encouraging both prime contractors and grantees to engage women and minority business enterprises in subcontracting opportunities (new Public Utilities (PU) Code §§ 8283(a) and (b).

2. It mandates the Commission to establish guidelines for all subject utilities to be used in establishing programs pursuant to the new legislation (PU Code § 8283(c)).

3. It mandates that subject utilities furnish an annual report to the Commission regarding implementation of programs (PU Code § 8283(d)).

4. It requires the Commission to provide an annual report to the Legislature beginning in January 1988, on the progress of activities undertaken by subject utilities in implementing F/MBE development programs. It further requires the Commission to recommend a program for carrying out the policy declared in the legislation (PU Code § 8283(e)).

5. It requires the Commission to develop and publish regulations setting forth criteria for verifying and determining the eligibility of F/MBEs for procurement contracts (PU Code § 8284(a)).

6. It requires the Commission to develop, and require subject utilities to implement, an outreach program to inform and recruit F/MBEs to apply for procurement contracts under the terms of the legislation (PU Code § 8284(b)).

In addition, AB 3678 makes certain findings, including definitions of "women-owned business" and "minority-owned business" both of which adopt a 51% ownership criterion (PU Code § 8282). In their letters asking for official notice of this new law, Public Advocates opines that its requirements are consistent with the relief sought by Minority Coalition. However, Pacific Bell asserts that this law does not require the "mandatory goals", which Minority Coalition asks for, adding that the legislation requires <u>self-identified</u> goals, and claiming that mandatory goals are in reality quotas, which the statute specifically prescribes.

On February 11, 1987 this Commission responded to the mandates of AB 3678 by issuing Order Instituting Rulemaking (OIR) 87-02-026. The OIR specifies that pending further order of this Commission the subject utilities which already must comply with F/MBE reporting requirements pursuant to previous Commission decisions are to continue filing future reports on their F/MBE programs as they become due, conforming to the requirements of those previous decisions. However, they are to be filed in the OIR proceeding rather than the utility's general rate case. This requirement of course is prospective and does not apply to the case at hand.

D. <u>Discussion</u>

AB 3678 calls for <u>annual</u> reports from the regulated utilities to this Commission. We see no basis for imposing on

Pacific Bell the more frequent standard proposed by Minority Coalition. Annual reporting of both Pacific Bell's plan for increasing women and minority business enterprise procurement and its implementation of F/MBE programs is sufficient.

As for the 2-tiered reporting system Pacific Bell suggests, we recognize that a great deal of Pacific Bell's purchases are for "technology-based equipment" and that there may not be a very large pool of minority or female suppliers for such equipment. However, we are not now inclined to grant such practice since this record does not convince us that Pacific Bell needs are so unique and large and the market is so poor that Pacific Bell will be unable to find any F/MBE suppliers, or that Pacific Bell's F/MBE statistics will be unavoidably and unfairly skewed without such treatment.

We believe that there is something of the chicken and egg dilemma going on here. It is likely that the pool of high technology F/MBE suppliers will increase if Pacific Bell actively seeks F/MBE contractors for these services. It is also likely that lack of high technology F/MBE procurement goals will translate to little effort on Pacific Bell's part to find new suppliers resulting in little incentive for the marketplace to expand. That expansion is one goal of the new legislation. In § 8281(b)(1)(F) the Legislature specifically finds that "[t]he procurement [of technology, equipment, supplies, services, materials, and construction work from women and minority businesses] also benefits the public utilities and consumers of the state by encouraging the expansion of the number of suppliers for procurements, thereby encouraging competition among the suppliers and promoting economic efficiency in the process.

Turning to the issue of effective verification of eligibility for status as an F/MBE contractor, we agree that Pacific Bell's present system is probably not sufficient to assure that all those claiming to be F/MBE contractors actually are. More

needs to be done. AB 3678 recognized that this is a problem and has provided criminal sanctions against those who falsely claim F/MBE status. Further, OIR 87-02-026 is addressing additional aspects of this problem. We are satisfied that Pacific Bell's dealings with contractors on this issue in the past were in good faith and were not intended to undermine its F/MBE program. Therefore, we find it inappropriate to take punitive action against Pacific Bell for the quality of its verification procedures. The ongoing OIR will undoubtedly arrive at verification procedures which are superior to those presently being used by Pacific and the other subject utilities. We will not now require any changes in Pacific Bell's verification procedure, but allow a broad policy to be developed in our OIR.

When it comes to the issue of the propriety of this Commission setting numerical goals, the parties diverge considerably. Minority Coalition says it is the reasonable and necessary means of assuring that Pacific Bell will make progress. DRA agrees that it is more likely that F/MBE participation in Pacific Bell's business will substantially increase if the Commission sets numerical goals. Pacific Bell, on the other hand, claims that such Commission action contradicts the language of AB 3678, which, in Pacific Bell's opinion, provides that goals are to be self-identified. Pacific Bell contends that the goals advocated by DRA and Minority Coalition are in reality quotas, and points out that the legislation specifically prescribes quotas.

Pacific Bell's interpretation of the statute is much too narrow. PU Code § 8283(b) says these plans are to include "goals and timetables, but not quotas", and § 8283(c) directs this Commission to establish guidelines to be utilized by the utilities in establishing such programs. Clearly this legislation does not advocate the hands-off approach suggested by Pacific Bell. Since this issue is specifically being addressed in the pending OIR, however, we will not set out any specific goals or timetables for

Pacific now, but will await implementation of a consistent program pursuant to the record now being developed in that OIR.

There was no dispute on the record with the propriety of the $1,068,500 which Pacific Bell asks us to adopt as its total budget for recurring and nonrecurring F/MBE costs for test year 1986. Were we to find that Pacific Bell's F/MBE program was a sham and a total affront to this Commission's prior orders, as Minority Coalition seems to suggest, we would be inclined to deny the expense. Our conclusion though, is that while Pacific Bell's F/MBE program is inadequate, and its commitment has not been nearly so strong as we would like, Pacific Bell has proceeded with its program in compliance with our prior orders. This is not to say that we are satisfied with Pacific Bell's accomplishments. We are not. For example, we want the number of reporting categories Pacific Bell now uses to be expanded. Further, the statistics, as unreliable as they are, quite obviously show that Pacific Bell has not done business with F/MBE businesses in significant numbers. We want it to do so, and we believe that it is beginning to do so. We are certain that the effect of AB 3678 and R.87-02-026 will more clearly focus attention on the "how" and "what" of F/MBE programs and assure swifter and more fundamental change than we have so far witnessed. Until that proceeding is completed we will avoid instituting piecemeal procedural requirements. Since we have found that Pacific Bell has complied with our orders on this subject and since the 1986 projected cost of implementation appears reasonable, we will adopt Pacific Bell's proposed F/MBE budget for test year 1986.

VIII. The San Ramon Valley Complex

A. Background

The San Ramon Valley Complex (SRV) is a two-million square foot administrative complex designed to accommodate approximately 7,350 employees. Prior to SRV, Pacific Bell's

administrative work force was partially housed in 49 different leased locations in the greater Bay Area, but primarily San Francisco. After SRV that same work force will now be housed at SRV and five San Francisco locations (four owned and one leased).

Pacific Bell decided to build SRV, rather than to continue leasing office space, based on an economic analysis conducted in 1981-1982. It purchased the 100-acre site in January 1982. In May 1982, it formed an in-house project team to formulate design and oversee construction. In August 1982, it selected the architectural firm of Skidmore, Owings & Merrill (SOM), and in November 1982, it selected general contractor Swinerton & Walberg Co. (S&W).

Conceptual design was completed in December 1982. Contra Costa County Planning Commission approval was obtained in February 1983. Ground breaking occurred and construction commenced in April 1983. Initial occupancy occurred in January 1985, and SRV was ultimately completed in the May/June 1986 time frame. The total project interval was reduced by approximately two years because SRV was constructed according to the "fast track" method, rather than the "traditional" method.

Under the traditional method, the bid process does not begin until project design and all contract documents are finalized. Once drawings are final, bids are solicited on a lump sum basis from general contractors. Therefore, bids are based on supplying all labor and materials in accordance with the architects' and engineers' drawings and specifications, all for a specified sum of money. The advantages of this system are that it produces a project for the lowest construction cost, at a fixed price, and presumably with minimal changes due to oversights or omissions attributable to the design phase. The disadvantage of the traditional method is that it is time consuming, resulting in the owner having to absorb costs of inflation, construction

financing, existing rental leases, and time loss in operational occupancy (Exhibit 560, pp. 5-6).

The fast track method accelerates the timetable for start of construction and compresses the delivery time. This occurs because construction begins before the design process is complete. For example, once the drawings and specifications for site clearing and grading are completed, that specific phase is let for bid and work commenced while the design process is being completed for the next phase (foundations). This process is repeated from one phase to the next until the project is completed.

Under fast track, specifications for each of the sequentially phased bid packages are developed by the architect and engineers; the general contractor coordinates the letting and awarding of bids to the subcontractors. The advantage of fast track is that significant savings can result from the time saved due to acceleration of construction and the compression of the project delivery schedule. The disadvantages are the errors, omissions, and oversights inherent in a time-driven project. In addition, the total cost is not definite until all sequential packages are bid.

SRV was ultimately completed in mid-1986 at a cost of almost $400 million. However, for purposes of this proceeding, Pacific Bell requests revenue requirement recognition of its SRV investment based on an earlier estimated building construction cost of $230 million (Exhibit 197; TR. 20344-20345).

B. Phase 1 Ratemaking Treatment

In Phase 1 of this proceeding TURN's witness DiGiacomo[13] testified, based on his firm's experience at SRV, about lack of

13 DiGiacomo is chief executive officer of DiGiacomo, Inc., a construction firm specializing in artificial lakes, waterfalls, and ornamental rockwork, which at one time worked on the SRV project.

coordination between S&W and its subcontractors, disruptive design changes, and questionable change order practices. The tenor of DiGiacomo's testimony was that the entire SRV complex was mismanaged and would result in excessive ratepayer costs. Pacific Bell presented two witnesses in rebuttal, who explained the fast track process, and Pacific Bell's procedures for controlling change orders (Exhibit 197). (See D.86-01-026, mimeo. pp. 187-191.)

Based on the record developed in Phase 1, we decided to cap ratepayer exposure at the estimated $230 million building construction cost, set rates subject to refund, and require DRA to audit the project and present its recommendations in Phase 2. Our rationale was as follows:

> "From what we have heard as evidence thus far, we cannot conclude as stongly as TURN that things are 'rotten' surrounding construction of the SRV complex, but we are left with the uneasy feeling that job site coordination problems could lead the costs to escalate. We greatly appreciate the effort of TURN and diGiacomo to focus attention specifically on the SRV complex, but without knowing more we conclude that at a minimum a constructive and fair measure of protection for ratepayers is to hold PacBell to its current view of total building construction cost, derived about half way through the construction, which is $230 million (Exhibit 197, page 2). Despite adopting such a cap on building costs we nevertheless want our staff to investigate diGiacomo's contentions to determine if, from its view, our $230 million cap is too generous or results in allowing excessive building costs. TURN's contribution on this issue is significant.
>
> "We trust our staff has the resources to follow up in investigating the contentions raised by TURN. Certainly one lingering question is whether PacBell's contract with Swinerton was set up to minimize project costs, because it appears Swinerton's compensation is set as a percentage of project cost, i.e., the more the project costs the more compensation Swinerton receives. PacBell's rates set today are

> subject to refund, and we will welcome further analysis of these issues by our staff and other interested parties, with their findings or recommendations presented in the next phase of these proceedings during 1986." (D.86-01-026, mimeo. pp. 191-192.)

We provided in Ordering Paragraph 14 of D.86-01-026 that:

> "The maximum amount which PacBell shall book to plant in service for building costs in connection with its San Ramon Valley complex is $230 million, exclusive of land costs, and ancillary IDC shall be derived in view of the cap on building costs."

It appears that we provisionally accepted Pacific Bell's prima facie showing, limited to the initial $230 million projected building construction cost, rather than the increased $353 million projected during Phase 1, although we set rates subject to refund and designated the issue for further record development in Phase 2, to consider whether the $230 million figure was appropriate for test year 1986, or whether it should be reduced due to overgenerousness.

C. Phase 2 Evidentiary Showings

1. Introduction

The active parties on the SRV issue in Phase 2 were Pacific Bell, DRA, and TURN. While only Pacific Bell and DRA presented testimony during Phase 2, all active parties developed the record through cross-examination and thereafter submitted SRV arguments in their opening and reply briefs.

These parties have differing views about the crux of the SRV issue. Pacific Bell has made an evidentiary showing designed to demonstrate the prudency of its decision to construct SRV, the cost-effectiveness of the fast track approach, the reasonableness of the associated contractual terms, and the rigor of its oversight of the construction process.

DRA believes, on the other hand, that the key issue is the decision to build, and Pacific Bell's overstatement of the ratepayer savings associated with constructing SRV, based on use of an inappropriately derived discount rate which penalized the "continue to lease" option. This means, in DRA's view, that the ratepayer exposure should be capped at a level of approximately $178 million, which is lower than the present $230 million cap, and approximately $200 million lower than the total project costs shown in Exhibit 542.

TURN argues that our Phase 2 order should affirm the $230 million cap imposed in D.86-01-026, and clarify that any construction costs and related interest during construction (IDC) above this cap are disallowed, based on findings that (a) Pacific Bell's decision to proceed with SRV construction was imprudent; (b) the S&W contract was imprudent; and (c) Pacific Bell's "passive" management of SRV construction was imprudent.

2. <u>The Results of DRA's SRV Audit</u>

In response to our Phase 1 directive, DRA presented its SRV Audit Report (Exhibit 542), which focused on Pacific Bell's budget controls and change order procedures. The audit concluded that:

1. The SRV project was originally planned in 1980 to meet a forecasted need for additional office space of 731,000 square feet by 1990. In addition, the project was apparently sized based on the anticipated participation of AT&T to occupy 600,000 square feet. Since that time AT&T is not a participant and there has been a sizeable reduction in Pacific Bell's work force. The net effect of the addition of SRV will be a substantial increase in the square footage allocated per employee. Therefore, it appears need for additional space is not the impetus for the SRV project.

2. The only justification for the SRV project staff was able to glean from this investigation is economics. Pacific Bell

claims a $200 million savings. Staff will provide its own economic assessment under a separate cover.

3. In Phase 1 of this proceeding Pacific Bell identified total SRV cost to be approximately $350 million. Based on more current estimates obtained by staff total cost is now put at $400 million. However, these costs are not all inclusive but only the identifiable costs specific to construction. For example, cost to relocate employees is estimated to be $40 million. To properly evaluate a project and for future ratemaking purposes all cost associated with the project must be identified. Accordingly, staff recommends that Pacific Bell be required to assign a tracking code to all SRV costs.

4. Pacific Bell's contract with the general contractor is for actual cost plus a profit with no economic incentive for timely completion. The alternative method of contracting would be lump sum bid in which the general contractor would assume risk of completion of the project for a bid price. Pacific Bell's method of contracting for the SRV project put the company in the same risk position that would normally be assumed by a general contractor under a lump sum bid approach. It is the staff's position that Pacific Bell has acted imprudently by assuming a level of risk inappropriate for a public utility. Accordingly staff recommends that all risk for the SRV project be shifted to Pacific Bell's stockholders. That is, the ratepayer should be left in a no worse economic position than if the company had done nothing. Staff will provide an economic study proposing a maximum "cap" for the SRV project by February 18, 1986.

5. Change orders are an area of vulnerability for a fast track project and therefore require careful controls. Change orders for the SRV project currently total $120 million. After an examination of the records staff concludes that Pacific Bell

has done a poor job of controlling change orders. The company's difficulty in this area correlates to their lack of management expertise for a project of this magnitude and the lack of economic incentives for the general contractor. This finding supports the conclusion in Finding 4.

6. The company's system of internal controls is not adequate to control a "nonroutine" large construction project. Specifically, the identification of the potential for significant cost overruns does not come until late in the process when it may be too late for corrective action. This finding is indicative of Pacific Bell's lack of in-house expertise for this type of project and also supports the conclusion in Finding 4.

Despite these conclusions, in its brief, DRA stated that it was making no recommendation concerning Pacific Bell's management procedures since construction of SRV was a one-time event, rather than part of ongoing operations. Instead DRA conducted an economic study of SRV project economics to determine cost-effectiveness from the ratepayer perspective. The underlying theory of this analysis, discussed in a subsequent portion of this decision, was that, if the ratepayers have not been harmed, Pacific Bell bears no fault.

3. <u>Pacific Bell's Position</u>

a. <u>Pacific Bell's Analyses of SRV</u>

Pacific Bell asserts that it has demonstrated its analyses of SRV were technically sound, reasonable, and accurate, identifying SRV as the best approach to meeting its administrative space requirements. It claims to have examined all the

alternatives to building SRV, given work force projections[14] and the desire to consolidate its administrative work force.

In late 1981 and early 1982, when the utility initially reviewed the option of obtaining additional leased space, it encountered extremely low vacancy rates in San Francisco; further, it was unable to secure sufficient blocks of leased space elsewhere in the Bay Area to further its consolidation goals. It also believed the economics of leasing were unattractive and the forecasts were unpromising for at least 5-10 years (Pacific Bell opening brief, p. 223). After performing a discounted cash flow analysis (using the CUCRIT model)[15] which showed leasing to be costlier than owning, it eliminated the lease alternative.

It began looking for appropriate building sites, and settled on the 97-acre Bishop Ranch site. This site was practically ready to build on because utilities and other site improvements were in place. The site also had other advantages, including a favorable local development climate, a reasonable commute situation, freeway proximity, and transportation potential; it also afforded protection of Pacific Bell's investment due to the quality of surrounding real estate developments. After acquiring the site, Pacific Bell began planning for actual construction.

b. <u>Planning and Construction of SRV</u>

Initially, Pacific Bell appointed a project director who staffed the Core Project Team, which had direct responsibility for

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14 In 1981, Pacific Bell estimated that it would need to house 17,000 employees in San Francisco in 1990 (Exhibit 549, p. 13).

15 Five alternatives were considered:

(a) Lease in San Francisco.
(b) Lease outside San Francisco.
(c) Own in San Francisco.
(d) Own other than in San Francisco.
(e) Sale-leaseback arrangements.

project management by maintaining accountability of the architect/engineer and the contractor. The Core Project Team developed a management plan which established a method for constant schedule control and procedures to communicate planning actions, project status, and specific targeted goals. It also developed specific design concepts.

In August 1982 the Core Project Team selected the architect, SOM, after a lengthy and elaborate search, conducted with the assistance of an outside architectural expert.

The Core Project Team also decided, in conjunction with the selected general contractor/construction manager S&W, to use the fast track construction method. Pacific Bell asserts that the time savings from fast track translated into significant financial savings, and that fast track also afforded it more leverage in hiring subcontractors, than the traditional delivery system (where all subcontractor work is let and bid at once).

Addressing the issue of the reasonableness of the S&W contract, Pacific Bell maintains that the terms involve a percentage fee contract with a cap on both the fee and the field office overhead. The fee percentage is 1.25% of construction costs up to a maximum of $2.2 million. Field office overhead is limited to a stated maximum of $3.3 million. While the contract contained no explicit incentive clauses, Pacific Bell's Basler believes there were at least three economic incentives to perform:

> "First, the contractor is responsible for site overheads, which are limited by the contract. If the contractor's performance is below par, resulting in a delay, the requirement that he bear the costs of additional overheads will quickly cut into his profit. This is a substantial economic incentive. Second, although he may not be formally penalized for delay and cost overruns, the fact that the contractor can earn no more than $2.2 million on this project provides strong incentive to complete the project on schedule. The cost of keeping key personnel on a job longer than necessary is usually substantial. Third, poor

> performance on a major project such as this one can damage the firm's reputation and thus limit its ability to secure other jobs." (Exhibit 549, p. 51.)

In defending the absence of specific incentive clauses, the utility asserts that such clauses often have negative effects and may result in overdelegation of project control to the general contractor. Thus the absence of specific incentive clauses should not, in its view, be taken as a sign of imprudence.

Pacific Bell also maintains that ratepayers were protected in that a majority (80%) of actual construction costs were arrived at by a competitive bid process.

Once the commitment to fast track was made, the crucial decision to upscale SRV followed. The Core Project Team worked with SOM, deciding to use fast track construction to build the project continuously, rather than in phases as originally planned. Further increases in scope[16] raised the original construction budget by approximately $40 million (Pacific Bell opening brief, p. 228), and increased gross square footage to the present 2.05 million figure.

The subcontractor bid process and the change order processes were crucial to the project. The general contractor, S&W, sequenced all work, while SOM kept it informed of the sequence in which the bid packages would be completed. Thus, SOM could sequence the order of subcontractors on site. The Core Project Team developed a change order process to document alterations in

16 Expansion of central office, construction of a data network management area, installation of a network management center, development of computer space for accounting, enhancement of conference centers, improvement of SRV telecommunications, upgrading of SRV's audio-visual capabilities, improvement of the building automation system, and addition of small computer rooms in the wings.

the work scope not quantifiable at the time the bid package was issued. Most of these changes typically were less than $5,000 each. (Exhibit 549, p. 43.)

SOM, S&W, and Pacific Bell were all involved in the change order process. The subcontractor identifying the needed change would initiate the documentation and submit it to S&W for review. When S&W was satisfied that the work was necessary and the quote correct, a change order would be forwarded simultaneously to SOM and to Pacific Bell for their individual independent reviews.

Such change orders were reviewed by Pacific Bell's construction coordinator, its estimator, and by an engineer accountable to the Core Project Team. Often outside consultants were asked to verify quantities and costs. Many times, as a result of these reviews, subcontractors were required to conduct detailed quote reevaluation, resulting in substantial savings.

SOM's project manager reviewed each quote and referred it to one of its team of 17 engineers responsible for change order review. If either SOM or Pacific Bell questioned the quote, the matter was sent to S&W for review. Only after this extensive process was completed was a change order finalized for approval and payment.

Pacific Bell's witness Friedman, a professor of architecture at UC Berkeley, reviewed the SRV change order process and concluded: "There is little question in my mind about the meticulousness and care exercised in the change order process, in many cases a process that was operative after the fact - which is a necessity in the fast track system and which is recognized as an acceptable risk." (Exhibit 560, p. 15.) Friedman concluded that the savings resulting from early delivery of the project more than

justified the additional project costs associated with fast track.[17]

In sum, Pacific Bell believes it has demonstrated that it protected the ratepayer interest by capping the contractor's fee and overhead, by getting competitive lump sum bids in 80% of the project, and by utilitizing its Core Project Team to assure, on a day-to-day basis, that the project would be timely completed. In addition, it believes it provided S&W the incentive to complete the project in a timely and cost-efficient manner.

4. **DRA's Position**

DRA's witness Thompson's analysis of SRV project economics concluded that SRV was noncost-effective in comparison to the alternative of continuing to lease space in San Francisco. In particular, DRA concluded that Pacific Bell's net present value study had inappropriately inflated the cost of the leasing alternative by applying to it a so-called FIN ADJ adjustment, or "equity penalty." The result was to make SRV appear cost-effective when it truly was not.

In Phase 1 Pacific Bell claimed that SRV would save ratepayers $200 million in present value revenue requirement over its life. This calculation was made by subtracting the present value of the revenue requirement associated with owning SRV ($428 million) from the present value associated with the leasing alternative ($634 million), using the CUCRIT model.

DRA attempted to replicate the utility's calculation of leasing costs, in order to isolate differences in methodology. It also attempted to verify that the inputs to the calculation of

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17 Friedman assumes that cost of a fast track project would exceed that of a comparable lump sum bid project by 1-2% of the construction cost-in this case between $2.5-$5 million. His worst case scenario estimates this additional cost at $7 million, which is 3% of the construction costs.

lease cost were reasonable, and finally to calculate the rate base equivalent to the cost of leasing. If the rate base equivalent was equal to or greater than the cost of SRV, then DRA would recommend full recovery. If it was less than SRV cost, DRA would recommend the rate base equivalent figure as a cap.

DRA initially calculated a cost of leasing of $256 million, which differed from Pacific Bell's $634 million figure by $378 million. The major reason for the difference is the FIN ADJ adjustment factor Pacific Bell added to the cost of leasing calculation.

In subsequently verifying the inputs to its calculation, DRA made certain modifications that resulted in $18 million being added to the cost of leasing, resulting in an ultimate cost of leasing per DRA of $280 million.

As a final step, DRA derived a rate base of $177.2 million, which equates to a present value revenue requirement of $270 million. This is the rate base value that places SRV on equal footing with the leasing alternative, and therefore, the maximum the Commission should allow for SRV, in DRA's view.

The dispute over applicability of FIN ADJ is crucial to understanding DRA's recommendation. Pacific Bell explains that FIN ADJ is necessarily added to the CUCRIT model to compensate for the fact that leasing cash flows are being discounted at the cost of money instead of the cost of debt. DRA's Thompson acknowledged that Pacific Bell correctly described the textbook treatment for a lease/borrow decision. However, the choice between building SRV and leasing space in San Francisco is not a lease vs. borrow decision per se, but a mix of a capital budgeting decision (i.e., SRV or SF) complicated by the fact that the choices are financed differently (i.e., lease vs. buy), DRA's views this as much more involved than the strictly textbook analysis.

The theoretical justification for the financial adjustment term "FIN ADJ" was to compensate for the increased risk

of leases. That is, since leases are similar to debt financing, the choice of the lease option, instead of a purchase financed with a composite of capital, will increase the debt ratio in the capital structure and thus the overall risk of the firm. In contrast, DRA asserts the real ratemaking issue in this case is whether there is an additional financial cost associated with the leases of office space in San Francisco that translates into a ratepayer cost.

DRA believes there is no such additional cost. In arriving at this conclusion, DRA considered the impact of leases on Pacific Bell's financial ratios; consulted with the major rating agencies Standard and Poors, and Moodys; compared Pacific Bell's posture in the rate of return portion of the general rate case, in which financial issues are debated, with its position in this portion of the rate hearings.

DRA's findings are:

1. DRA measured the impact of leases on Pacific Bell's financial ratios. Table 3 of Exhibit 543 shows the impact of leases on three-key financial variables. From this analysis staff concluded that the elimination of all leases of office space, not just SRV, would not have a material impact on Pacific Bell's financial position. For example, the elimination of leases will result in a shift in the debt ratio from 49.2% to 48.8%, a change of only .4%. (Exhibit 543, Table 3.)

2. The rating agencies consider many factors in assessing the overall risk of a firm for the purpose of assigning a debt rating. One of those factors are the financial ratios. However, financial ratios are viewed within ranges of acceptability and, therefore, a very small shift in these ratios would not, in and of itself, create a change in the perception of risk. (Exhibit 543, Table 3.)

3. The notion of a target capital structure is theoretical and, therefore, cannot be precisely calculated but only estimated.

(Cross-examination of witness Copeland, TR. 12703.)

4. The leases associated with the SRV issue are operating leases and not financial leases (Exhibit 543; Exhibit 712). Moody's does not consider operating leases in evaluating risks. Standard and Poors does consider operating leases but only if they are material (Exhibit 543).

5. Pacific Bell has never raised the issue of the financial risk of leases in their rate of return showings before this Commission. This is inconsistent with their position regarding the SRV issue.

DRA's conclusions are:

1. That the inclusion or deletion of the leases associated with office space do not impact Pacific Bell's financial position and, therefore, does not translate into a ratepayer cost that should be considered in comparing the alternatives.

2. Pacific Bell has chosen to selectively apply their argument which is their "centerpiece" in proving that SRV is cost-effective.

Therefore, DRA submits that application of the FIN ADJ adjustment is inappropriate. That being the case, DRA asserts its calculation of the lease cost alternative ($280 million) is more credible than Pacific Bell's $634 million figure.

5. <u>TURN's Position</u>

TURN believes the Commission should disallow a substantial portion of Pacific Bell's SRV investment. It asserts that the $230 million cap on nonland construction expenses for SRV, imposed in D.86-01-026, must remain in place, since that determination was never challenged successfully, and has long since become final under PU Code § 1709.

TURN believes that D.86-01-026 effectively determined that Pacific Bell had failed to meet its burden of proving that SRV costs were reasonable. According to TURN, the Commission disallowed construction costs above $230 million and directed DRA to audit SRV costs to determine whether even this ceiling was too generous.

TURN submits that the reasonableness review of SRV turns on an analysis of timing. It appears to TURN that the utility had decided to build SRV before ground was broken, and that top management never reassessed this decision in the light of changed circumstances. Two decisions are key: the first was the decision to purchase land in San Ramon in January 1982; the second was the decision to build SRV in its current size and configuration sometime after January 1983. TURN believes the record is devoid of any information about evaluation of alternatives to construction which may have occurred during 1982. TURN submits that the lack of such information makes it impossible for the Commission to determine whether the decision to begin construction of SRV was reasonable.

A 1981 forecast was used to project the size of Pacific Bell's work force and its need for space. TURN maintains that there is no indication that this forecast was ever reevaluated in the two years prior to commencement of construction, even though the economy was exhibiting slower growth trends and the AT&T divestiture should have raised questions about the need for such a large work force. In view of this, TURN believes Pacific Bell has failed to prove that SRV was necessary.

In addition, cost comparisons with retained leased space in San Francisco had changed dramatically between 1981 and 1983. TURN cites a Coldwell-Banker analysis discussing the dramatic change in the market during late 1982 and early 1983. The same analysis shows the change in the relevant vacancy rates during the same period:

December 1981	0.4%
March 1982	0.8%
June 1982	3.4%
September 1982	3.6%
December 1982	5.7%

TURN finds it shocking that Pacific Bell failed to notice at least some impact of a 10% fall in office costs and a 15-fold increase in office availability during a time when it was preparing to embark on its largest real estate venture in decades. TURN believes that the utility's failure to thoroughly reexamine its options prior to breaking ground in 1983 was imprudent.

TURN also maintains that the utility's construction contract was imprudent. It believes Pacific Bell's witnesses have painted too glowing a picture of the fast track construction process while simultaneously underestimating the cost risk factors associated with the process.

TURN also faults the contract with S&W. The implication of Pacific Bell's testimony is that S&W's profits cap would be reached once contract-related construction costs reached $176 million ($2.2 million is 1.25% of this amount). But TURN disagrees that a cost cap really exists, since the utility's characterization of the contract does not reflect the many renegotiations and changes in SRV design and construction. According to TURN, no witness was able to say whether the original fee or overhead caps had been raised as part of these changes, "so there is no evidentiary basis in this record for the Commission to find that any such cap remains in place, and what that cap would be." (TURN opening brief, pp. 49-50).

TURN also criticizes the practice of allowing S&W to subcontract with itself (which occurred with about 10% of the total SRV work). According to TURN, this destroyed the only significant counterincentive to inefficiency built into the S&W contract, and was therefore imprudent.

TURN faults Pacific Bell for rejecting the other alternative protection which would have been a guaranteed maximum price for the contract (TR. 11877-11878).

Finally TURN believes that Pacific Bell's own internal auditors' notes demonstrate a lack of active on-site review, as well as lack of supervision of the change order process (TURN opening brief, p. 56). Again, such passive management was imprudent, in TURN's view.

In sum, TURN believes a disallowance is appropriate since Pacific Bell imprudently began the SRV project, and thereafter imprudently pursued it. TURN believes DRA's recommendation to hold ratepayers harmless by capping actual recovery at the cost of the cheapest alternative is therefore appropriate.

D. Discussion

1. Introduction

Initially an observtion about burden of proof is in order. While we directed DRA to investigate SRV to ascertain whether the $230 million cap was too high, and present its findings in Phase 2, we did not shift the ultimate burden of proof of reasonableness from Pacific Bell. We are guided by the fundamental rule that rate recovery for SRV is permissible only if Pacific Bell meets its burden of proof as to the reasonableness of (a) its decision to undertake SRV, and (b) its management of SRV construction costs.

2. The Decision to Construct

There are essentially two reference points to analyze. The first is whether Pacific Bell accurately calculated the savings associated with the decision to construct. The second is whether Pacific Bell took account of changed circumstances in deciding to proceed with ground breaking in 1983.

a. The FIN ADJ Dispute

DRA has presented evidence that SRV savings were overstated by inappropriate use of FIN ADJ. DRA's analysis is that

the elimination of all leases of office space, not just those impacted by SRV, would not have a material impact on the utility's financial position, since the debt ratio changes only from 49.2% to 48.8%. DRA's innovative argument that Pacific Bell's textbook justification for using FIN ADJ does not translate to ratemaking reality has some appeal, if we are to attempt to assess actual ratepayer impacts. However, Pacific Bell persists in arguing that DRA's analysis fails to recognize the basic equivalency of leases and debt financing, recognized by the weight of academic authority. More specifically, DRA's cost of leasing alternative uses the utility's weighted average cost of capital as a discount rate versus the after tax cost of debt, supported by such academic authorities. The dispute over the appropriate discount rate, is not easily resolved, because both parties' analyses are done from differing perspectives (academic vs. ratemaking), and both have some credence.

However, in further response to DRA's showing, Pacific Bell presented the testimony of Dr. Robert Meyer, the associate dean of the School of Business at UC Berkeley. Dr. Meyer performed 12 restudies of the SRV project using escalation costs ranging from 7% to 15%. Some studies were run with FIN ADJ, and some without. The project proved to be robust even when the lowest escalation rate of 7% was used and the consideration of the risk of lease as represented by FIN ADJ was backed out of the computations. The ownership savings were greater when 10% and 15% escalation rates were used (Exhibit 558, Exhibit 1.)[18]

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18 PSD has criticized the wide savings ranges noted in Dr. Meyer's restudies: $56 million to $4.9 billion. Pacific Bell explains that the forecasts and assumptions used in its initial SRV studies were much more stringent than those used by Dr. Meyer in the restudies and established a conservative bias against the ownership alternative. (TR. 12070.) (Pacific Bell reply brief pp. 170-172.)

Thus, Pacific Bell has demonstrated that even without FIN ADJ, the decision to construct was supportable, based on the Meyer restudies.

b. <u>Changed Circumstances</u>

TURN's criticism that Pacific Bell failed to reassess the need for SRV prior to ground breaking, in light of the softening rental market for office space and divestiture impacts, appears to be contradicted by the evidence. First, Pacific Bell's Basler testified that it was never contemplated that AT&T would occupy any portion of SRV (Exhibit 549, p. 48). Second, Basler acknowledged that divestiture and companywide force reductions significantly impacted the forecasts supporting Pacific Bell's original SRV studies; however, updated forecasts were received and analyzed, and at the time Pacific Bell decided to enlarge SRV to its present capacity, it did so using the entire Bay Area as a population base, not just San Francisco. This allowed for further consolidation of the work force, termination of four additional leases in San Francisco, and significant space reductions in Oakland and San Jose (Exhibit 549, pp. 48-49). Pacific Bell has met its burden of proof on this issue.[19]

3. <u>The S&W Contract</u>

We expressed "lingering questions" about the S&W contract in our Phase 1 decision. Specifically, as this record indicates, S&W's profits cap would be reached once contract-related construction costs reached $176 million ($2.2 million is 1.25% of this amount). A question arises about the impact of change orders

19 In so finding, we do not rely on PSD's testimony at TR. 11578-11579, which we believe has been inappropriately characterized in Pacific Bell's briefs. PSD's witness merely acknowledged that, based on the utility's $200 million savings assessment, the utility believed it was cost-effective to continue with SRV, despite a softening of the rental market. From PSD's perspective, this is a far cry from agreeing with the fact of cost-effectiveness.

on this cap. TURN says there is no evidence that the cap really remains in place, or whether it is raised to account for these renegotiations. Pacific Bell's response is oblique; it states: "Even if S&W were successful in renegotiating its fee on the basis of the expanded scope of the project, each $10 million in project costs would equal only $125,000 in increased fees." (Pacific Bell reply brief, p. 182.) Thus, we are left in the dark about the actual status of the current arrangement with S&W, given the final expanded cost of SRV.

TURN has also raised questions about the contract's lack of explicit incentives; Pacific Bell's response cites the existence of implicit incentives. As witness Friedman notes: "In either case [fast track or traditional method], it is in the best interest of the general contractor and subcontractors to finish the project as soon as possible, since in both cases their profit and overhead reflects a fixed amount of money." (Exhibit 560, p. 8.) Eighty percent of the project's work was bid on a lump sum or unit price basis, which allowed the advantages of early completion, as well as the security of the lump sum bid.

Pacific Bell also effectively refutes TURN's self-dealing argument by noting that S&W's compensation (for its own subcontracting efforts) was <u>limited</u> to reimbursement for actual labor, direct supervision, and material costs <u>excluding</u> any overheads, profits, and management service fee (TR. 6222).

Given the above testimony, our only remaining reservation about the contract relates to the impact of change orders on the contract cap. It is presently unclear whether the fee has been renegotiated, and if so, under what terms. However, this is an issue for a future ratemaking proceeding, to be reviewed at the time Pacific Bell seeks additional rate recognition for SRV (TR. 20344-20345).

4. <u>Site Management</u>

The criticisms of Pacific Bell's oversight of SRV construction are effectively countered by Friedman's testimony describing the fast track process and his independent review of Pacific Bell's project management. As Friedman notes:

> "Pacific selected, from 'in-house,' a six person Project Management Team with varied construction expertise including architectural, construction administration, estimating, mechanical and electrical engineering, telecommunications engineering and space planning and furnishings. This team, although called the Pacific Project Management Team, actually became the Construction Manager for the Project, and performed most ably.
>
> "The architect Pacific selected, Skidmore, Owings and Merrill, possessed the requisite expertise in fast tracking projects.
>
> "Swinerton and Walberg, Pacific's general contractor, possessed the necessary fast track expertise and resources to execute the project and assist with the construction management.
>
> "Success in the fast track process necessitates a strong, experienced and knowledgeable Project Management Team representing the Owner. I held a series of interviews with key personnel, familiarized myself with their modus operandi and analyzed their respective performances, all of which convinced me that this Project Management Team was indeed competent, devoted and multi-talented. They had complete knowledge of the risks, hazards, pitfalls, respective costs, penalties and premiums for a project of this nature. This was clearly evident by the process they put in place ensuring management control, review and scrutiny of the project as it moved from stage to stage.
>
> "I not only found their control and review procedures meaningful and perceptive, I also found, to their great credit, that they attempted consistently to enforce the

> construction budget and time schedules, with no sacrifice to quality.
>
> "I also found they had no reluctance to avail themselves of professional consultants, where and when appropriate, to reinforce, augment, or provide assistance to them as the project progressed.
>
> "There are many examples of the latter, ranging from the initial phases of the project, when outside professional consultants were brought in to review and assist in compiling the Owner's program of needs and the selection of an architect, to special consultants for review and counsel on irreconcileable change orders." (Exhibit 560, pp. 12-14.)

The one area that continues to concern us is change orders. However, witness Friedman termed the process "exhaustive," and fully controlled (Exhibit 560, pp. 14-15). And, responding to DRA's challenge, Pacific Bell argues that DRA's auditor Hill inappropriately concluded that the change order process was not being followed, based on her failure to discover that the review process was tripartite. Hill's sampling of 80 change orders (those exceeding $300,000) out of 1,966 total change orders (totalling $30 million) included valued-added enhancements to SRV totalling $26.6 million. Thus, Pacific Bell submits that DRA's claim of imprudence "apparently boils down to change orders worth $3.4 million." (Pacific Bell opening brief, p. 239.) Based on this record, we can only conclude that the challenges to the reasonableness of the change order process were not persuasive. However, we would like to revisit this issue when reviewing Pacific Bell's request for ratemaking recognition of amounts over the presently authorized $230 million.

5. <u>Ratemaking Treatment</u>

TURN argues that our Phase 1 decision disallowed SRV construction costs over $230 million, and ordered a Phase 2 review regarding possible overgenerousness of that $230 million cap. That

is not really the case. All we have before us in this rate case is the $230 million originally requested. We have not specifically reviewed costs over the $230 million, due to test year constraints. At the appropriate future time, Pacific Bell must make its case it if wishes to reflect the additional SRV construction costs in rates.

The issue before us is whether to retain the cap or reduce it. We believe, based on the preceding analysis, that the cap should be retained without reduction. Thus we make no change to the Phase 1 results of operations to account for Phase 2 review of SRV.

We will, however, require Pacific Bell to retain all data associated with its prior tracking of SRV costs to assist in any future review we may undertake of SRV costs exceeding those currently reflected in rates. Pacific Bell shall retain this data until further order of this Commission. In particular, at the time of such review, we will be interested in DRA's assessment whether these extra costs are reasonable in light of Professor Friedman's 3% "worst case" scenario for projects constructed under the fast track method. Additionally, we hope that this assessment will involve extensive review by DRA of the change orders executed during this project.

IX. Productivity

A. Background

We designated for Phase 2 review the issue of the overall labor improvement productivity factor to be applied in Pacific Bell's attrition filings for 1987 and 1988 (D.86-01-026, mimeo. p. 5).

Testimony was presented on this issue by DRA Program Supervisor Harry Strahl and by Pacific Bell's Division Level Manager Douglas Byrkit. Pacific Bell witness Michael Revelle also

testified on productivity issues in Exhibit 174 during Phase 1. The productivity issue was briefed by Pacific Bell, DRA, and CPIL.

In connection with our review of 1987 attrition issues, we reviewed Strahl's recommended productivity incentive plan, and noted Pacific Bell's general (albeit conditional) endorsement of such a plan; however, since Phase 2 briefs had not been filed at that time, we indicated our preference to defer consideration of the merits of the incentive proposal until the parties wishing to brief it had done so. Therefore, for purposes of 1987 attrition, we adopted Strahl's recommended 5% productivity factor based on testimony that this level is sustainable in the near term. (D.86-12-099, mimeo. p. 19.) As noted earlier, Pacific Bell has appealed this action, among others, to the California Supreme Court.

The outcome of today's decision on productivity issues will determine the factor applicable to Pacific Bell's 1988 attrition filing and, in the absence of a contrary Commission order emanating from the upcoming new regulatory framework proceeding, it will also apply to the 1989 attrition filing provided for in Resolution ALJ-160, issued October 28, 1987.

B. DRA's Productivity/Incentive Plan

DRA's productivity study, conducted at our direction pursuant to D.86-01-026, disclosed that it is relatively easy to gauge productivity gains in certain areas, but considerably more difficult to do so in other areas. DRA believes that even if it were possible to arrive at discrete utilitywide figures for each attrition year, these would only serve as a benchmark for purposes of the attrition proceeding, and would do little to stimulate true infrastructure productivity increases. The current attrition formula for labor attrition fixes productivity at a constant rate; if the utility exceeds this rate, its stockholders may retain the difference. DRA chides Pacific Bell for arguing for a 2.7% rate during the 1985 attrition proceedings, while the utility was realizing something closer to 8% (Exhibit 518, pp. 6-1, 6-2). DRA

believes this current productivity treatment does not benefit ratepayers in the long run, and does not improve the creativity of the utility's employees.

In view of these factors, DRA's witness Strahl recommends an incentive plan, described in Exhibit 518, as follows:

"a. A productivity factor of 3.5% should be adopted for 1987 and 1988. The staff's review suggests that this level could be easily sustained by PacBell until the early 1990s.

"b. The labor attrition formula should be recomputed after the attrition year using the actual realized labor productivity factor. If the actual factor is less than or equal to 3.5%, the incentive plan would not go into effect for that year.

"c. The incremental dollar amount computed (as verified by staff and other interested parties) would be disbursed with one-half refunded back to the ratepayers, and 25% set aside as an employee bonus plan fund.

"d. The fund should be administered by an employee group (management and craft) and disbursements made to selected employees and teams (management and craft) who were instrumental in creating and developing verifiable and true productivity measures.

"e. The amounts awarded to the selected employees and teams should be prorated on the basis of the amount of savings realized from the various measures and no cap should be placed on individual awards.

"f. A report on the employees' selections, amounts awarded and reasons for the awards should be filed with the Commission.

"g. A suitable amount should be allowed to accumulate in the fund so as to allow for disbursements during rate case test years (when the adopted attrition process is dormant). At the end of the third year, any residual amount in the fund should

> revert to a general bonus plan."
> (Exhibit 518, pp. 6-2 to 6-3.)

C. <u>Pacific Bell's Response</u>

Pacific Bell's response to DRA's proposed incentive plan is presented in Byrkit's Exhibit 585. However Byrkit's productivity testimony supersedes that offered by Revelle in Exhibit 174 during Phase 1, only if Pacific Bell's concerns about the overall attrition methodology are addressed favorably (TR. 14264, Exhibit 585, p. 15). More specifically, Revelle had recommended a 1.0% productivity factor unless the attrition formula was revised in conformance with Exhibit 174's recommendations. In D.86-12-099 we made several, but not all, of the modifications suggested by Pacific Bell, and that order is now being appealed.

Byrkit essentially endorses the notion of an incentive plan, since he favors the concept of allowing for a sharing of productivity gains between ratepayers and shareholders. He states: "An incentive approach would encourage Pacific to strive for a superior level of productivity recognizing that it would obtain a share of the benefits. Currently, Pacific, under the fixed methodology, assumes all downside risk if it doesn't meet the adopted level of productivity; it should be given an upside potential for superior performance." (Exhibit 585, p. 10.) However, Byrkit expresses serious reservations about certain aspects of DRA's recommendation, and suggests significant modifications in several areas.

First, he believes the target productivity rate of 3.5% is too high, and that 2.3% is preferable, based on his assessment of Pacific Bell's actual experience over the 1970-1985 time frame (2.1% average) and his calculation of the overall productivity level implicit in our Phase 1 decision.

Byrkit believes the DRA's choice of access lines/employees (ALPE) as a measure of productivity is inferior to Pacific Bell's measure, which uses labor costs/access line. While

DRA and Pacific Bell agree that "access lines" is an appropriate measure of output to use in assessing labor productivity, DRA's ALPE would use force level as an input, while Pacific Bell prefers use of total labor and labor overhead costs.

Byrkit also suggests modifications to the DRA proposal to ensure a 50/50 sharing between company and ratepayers. He objects to Strahl's proposal that the company's 50% share of productivity gains be split between its shareholders and an employee bonus plan fund (a fund to benefit specific employees who are instrumental in improving productivity). Byrkit believes this is an interference with management's prerogative to set the level and means of employee compensation. He also maintains that two successful programs designed to encourage employee productivity are already in place (the Employee Suggestion Plan and the Team Award Program).

Finally, Byrkit suggests that, in situations where Pacific Bell exceeds its authorized rate of return due to its share of productivity gains under the incentive mechanism, there should be an adjustment rate of return to allow Pacific Bell to actually earn and retain its share of the benefits associated with this superior productivity gain.[20]

20 According to the example provided by Byrkit for 1987 and 1988, assuming productivity improvements of 5.3% for both years, ratepayers would gain a reduction in revenue requirement of $323.95 million (for the two-year period). If all other things were equal, and the increased earnings achieved by the productivity improvement exceeded the authorized rate of return, $42.55 million in 1987 and $40.95 million in 1988 of the total $323.95 million in reduced revenue requirement would be refunded. Rate of return would be adjusted upward from the authorized 12.52% to 12.95% in 1987 and to 13.35% in 1988 to allow Pacific Bell to earn its share of the $126.05 million for the two-year period.

D. CPIL's Position

CPIL objects to both productivity indices proposed by DRA and Pacific Bell, arguing that the incentive should not be based on a straight labor productivity increase.

CPIL notes that to the extent automation replaces labor in the utility's operations, both proposed labor productivity measures will increase, yielding incentive rewards. However, this automation may, or may not, benefit ratepayers. If it does not benefit ratepayers in the form of greater efficiency or lower costs, it will nevertheless yield a higher index rating for incentive reward purposes. CPIL believes Pacific Bell is being given an incentive to eliminate labor gratuitiously, an incentive which exists whether or not automation leads to greater efficiency or lower costs.

CPIL maintains that the mechanism should be neutral vis-a-vis use of labor or automation to accomplish improved productivity. To attain such neutrality, CPIL proposes total normalized expenses divided by CCS (100 seconds of usage) and total normalized expenses divided by net access lines (NAL) as two measures which could be used. Standard accounting procedure for calculating "total expenses normalized" should be negotiated between DRA and Pacific Bell. Both the CCS and NAL measures of output should be divided into that standard as normalized year to year.

CPIL asserts that this methodology moves Pacific Bell toward overall efficiency, improvement through the better use of labor and equipment, and does not falsely reward Pacific Bell for simply converting to increased automation where there is no ratepayer benefit or efficiency gain in so doing.

E. Discussion

Based on analysis of the arguments presented, we are inclined to adopt a variation of Strahl's incentive mechanism for attrition years 1988 and, consistent with the prior discussion, for

1989 only. Our intent is to see how the mechanism works, and decide after the 1989 attrition year whether it should be retained as part of the overall regulatory framework.

We realize Pacific Bell still has significant concerns about the attrition formula, especially in the area of the application of the usage growth factor; it has appealed D.86-12-099 partially on that basis. Nonetheless we have indicated our willingness to review the attrition formula in the new regulatory framework proceeding, as we consider how to effect multiyear rate changes in such a framework. Thus Pacific Bell has a forum to air its concerns, and we do not believe Revelle's 1.0% productivity factor is fair to ratepayers in the interim.

We will adopt DRA's incentive proposal with the following modifications:

1. The adopted productivity factor for attrition years 1988 and 1989 should be 2.9%, which is half-way between the Strahl and Byrkit recommendations. The record demonstrates that levels above 3.5% are sustainable until the early 1990s (Exhibit 518, p. 6-4), but we choose the slightly lower figure in recognition of Pacific Bell's qualms about the present attrition formula.

2. We reject the notion that Pacific Bell should split its 50% share equally between shareholders and an employee bonus plan fund. The record does not demonstrate a pressing need for such an additional fund, and the intrusion into management's area of responsibility is therefore not justified in these circumstances.

3. We see no need to explicitly adjust Pacific Bell's authorized rate of return upward to allow it to retain benefits over this amount. Under present ratemaking conventions it will retain benefits over the authorized rate of return in any event.

4. Finally while there may be merit in CPIL's criticisms about the proposed productivity

> indices to be used in measuring any incentive reward, these issues were not detailed on the record. Thus, we do not adopt CPIL's index. We will use instead DRA's suggested access lines per employee index since DRA asserts this is an industrywide standard, and we have no basis to conclude that Pacific Bell's proposed standard would be superior to ALPE for purposes of this two-year incentive proposal.

F. DRA's Recommendation Regarding Competitive Bidding for Central Office Switching Equipment (COSE)

DRA recommends that the Commission direct Pacific Bell to adopt a competitive bidding plan for all COSE purchased for cutover after October 1988. The rationale is that a similar plan has benefitted General Telephone's ratepayers, by lowering costs and improving productivity and that the requirement is necessary also in the case of Pacific Bell to establish a clear audit trail to ensure that the utility is obtaining the best available COSE at the lowest life cycle cost. In DRA's view, the mandated plan should conform to the one currently used by General Telephone.

Pacific Bell opposes DRA's proposal, terming it a "forced selection process." In its view, awarding contracts on the basis of location-specific competitive bidding would increase maintenance, training, and parts inventory costs due to a mixing of technologies. In addition, in November 1985 Pacific Bell implemented a bidding process designed to identify a pool of three qualified vendors; in purchasing from these vendors, the utility negotiates contracts for numerous switches to be used at a variety of locations in order to achieve volume discounts; it believes this process is superior to DRA's proposal because it allows for negotiated volume discounts (and associated cost savings), while allowing Pacific Bell to retain the decision on product selection by location.

We will not adopt the DRA's recommendation, in view of Pacific Bell's counterarguments that the proposal is unnecessary and not necessarily superior to the current Pacific Bell's program. The plan adopted for General Telephone need not be extended to Pacific Bell merely because it is working for the former utility. Further, the plan was required for General Telephone in great measure due to its unique vendor arrangements, which do not apply here.

X. Separations and Settlements

A. Background

In the Phase 1 decision, we noted our inability to assess the test year industrywide effects of shifts in revenue requirements from access services to exchange services (SPF to SLU effects). This was due to the fact that we only had information about Pacific Bell's billings, and we specifically lacked data about the post-settlements effects of the other independent telephone companies' shifts in access billings. We concluded that the revenue requirements effects of these industrywide shifts must be considered in determining the test year revenue requirement of Pacific Bell and designated this as another Phase 2 issue. (D.86-01-026, mimeo. pp. 6 and 104.)

Pacific Bell takes the narrow view in its Phase 2 argument that the settled revenue impact of these industrywide shifts is $756,000 (Exhibit 618; Exhibit 726, p. 23). DRA, on the other hand, takes a more expansive view of the effects to be considered.

B. The Contested True-Ups

1. Introduction

Pacific Bell's Sawyer testified that there was a $.190 million revenue requirement increase associated with the Commission's requested true-up for the interLATA SPF to SLU shift.

Sawyer also recommended recognition of an additional $.556 million for the Extended Area Service (EAS) expense impact of interLATA SPF to SLU. Sawyer's recommended total is therefore $.756 million. (Exhibit 726, pp. 23-24.)

DRA, on the other hand, requests true-ups totalling a net $44 million revenue requirement decrease as shown in Exhibit 754 (Table A, lines 1 and 2) based on recognition of updated billed access revenues figures.[21]

DRA indicates that, in response to the Commission's direction that this issue be developed in Phase 2, it sent a data request (DR) (900-6) to all independent telephone companies (ICOs). DR 900-6 was designed to obtain the information necessary to calculate the revenue requirements impacts of the industrywide shifts, and to calculate the effects on Pacific Bell of FCC and Commission-ordered separations changes.

2. **True-up/Revisions for InterLATA <u>SPF to SLU Shifts ($9.368 Million)</u>**

DRA used settlement data provided by the ICOs in response to DR 900-6. This settlement data differs from that used in the Phase 1 decision. The ICOs also provided information about the incremental change in the interLATA <u>settlement base data</u> due to the interLATA SPF to SLU shift ordered by the Commission. Since this ICO settlement base data directly correlates to the ICO settlement data, DRA has considered it, and believes the revenue requirement

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21 These adjustments are detailed ($000) as follows:

1. InterLATA pool true-up: ($9,368)
2. EAS expense revisions: $14,099
3. Separations factors revisions: $22,984
4. IntraLATA pool true-up: ($72,540)

associated with the true-up must be considered. The impact is ($9,368).

Pacific Bell objects to this "update," and argues that if the Commission considers it, it must also consider an offsetting $11 million in access service settlements which Pacific Bell pays to General Telephone as compensation for the joint provision of intrastate Feature Group A access service. This would result in a $1.308 million increase in revenue requirements ($11 million less $9.368 million).

We will adopt DRA's ($9,368) true-up figure, since it is directly tied to the settlements base data obtained from the ICOs in DR 900-6. As such, it is part of the industrywide impacts attributable to the SPF to SLU transition, and these are precisely the impacts we wished to explore in Phase 2.

We will not adopt Pacific Bell's suggested $11 million offset, because the access service settlement with General Telephone is separate from the issue of interLATA access pooling. While Feature Group A payments do impact access pool settlements and EAS payments, even Pacific Bell's witness acknowledges that they are not part of interLATA access pooling (Exhibit 726, p. 18).

In addition we agree with DRA's argument that the exclusion of this access service settlement from the Phase 1 RO is not the type of oversight that can be corrected now, without reopening the entire interim RO for the purpose of correcting all other related errors.

3. <u>EAS Expense Revisions: $14.099 Million</u>

DRA notes that EAS expenses calculated in D.86-01-026 did not include the effects of the interLATA SPF to SLU shift. DRA's revisions include these effects as well as the true-up of the EAS settlement base, to reflect the SPF to SLU shift (DRA opening brief, p. 30). While Pacific Bell opposes this "update" for the same reasons noted in Section 2 above (including a similar Feature Group A argument), the DRA calculation is designed to capture a

further industrywide impacts of the SPF to SLU shift, using ICO provided data, and is therefore appropriately recognized.

4. **Separations Factors Revisions: $23 Million**

Pacific Bell and DRA mutually agreed to certain modifications to the separations factors as discussed by DRA's Low in Exhibit 617 (p. NCL-3). DRA calculates a $23 million revenue requirement associated with these changes.[22] Again, we see no reason not to recognize these revenue requirement impacts, premised on the agreed-upon modifications.

5. **True-up of IntraLATA Pool ($72.540 Million)**

Based on settlement information obtained from the ICOs in DR 900-6, relative to message toll and private line costs, DRA estimated that Pacific Bell's 1986 intraLATA toll revenues would be substantially greater than those adopted in D.86-01-026, which were based in late 1983 estimates. This true-up reduces Pacific Bell's revenue requirement by $72.540 million.

Pacific Bell opposes this true-up as well, given its narrow view that D.86-01-026 contemplated only a Phase 2 adjustment to reflect the shift in access service revenues and access settlements associated with the 1986 SPF to SLU transition (Exhibit 618, p. 3). It asserts that since the intraLATA toll billed and settled revenue impacts were estimated in D.86-01-026, there was no omission requiring correction, as with the interLATA access area. Additionally, in its view, the intraLATA SPF to SLU calculations are not linked to the intraLATA toll update revenue requirement issue. Finally, Pacific Bell also opposes DRA's argument that

22 In Joint Comparison Exhibit 754, Pacific Bell asserts the appropriate revenue requirement is $43.4 million, rather than $23 million, but, as PSD notes, this $43.4 million figure uses 1985 recorded separation factors as a base and grows these factors to a 1986 level. This is inconsistent with the 1986 factors developed in Phase 1, which were based on 1984 recorded separations factors.

failure to make the $72.540 million adjustment would provide the utility with a windfall. It points to other alleged understatements of expenses, rate base, and revenues that indicate in its view that its actual 1986 results are below the authorized rate of return.

While we used 1983 figures in D.86-01-026, and there was apparently no dispute about these figures or any real review of them, we also left the proceeding open to review "the effects of the industrywide shift of revenue from carrier access services on Pacific Bell's settled test year revenue" (D.86-01-026, mimeo. p. 6). Since the ICO-derived data is the basis for assessing these industrywide shifts, and the data shows additional revenues are indeed being realized by Pacific Bell, we believe basic fairness to ratepayers requires recognition of this reality. Therefore, we adopt DRA's ($72.540 million) figure.

C. <u>FCC Separations Rule Changes</u>

As Joint Exhibit 754 demonstrates, Pacific Bell and DRA do not dispute the need to reflect two FCC separations rule Changes: the change in allocation between State and Federal jurisdictions of Account 645 (local commercial) expenses, and the change in allocation between the two jurisdictions of investments and expenses for State and interstate WATS (Wide Area Telecommunications Service). These rule changes were effective June 1, 1986. The impact of the Account 645 rule change is $14.268 million; the impact of the WATS change is ($24.418) million (Exhibit 754, Table A, lines 3 and 4). We will adopt these agreed-upon figures.

XI. Miscellaneous Revenue Requirement Adjustments

A. IntraLATA SPF to SLU

1. Costing Methodology

One of the issues related to intraLATA message toll service is how to allocate costs. DRA's witness, Mr. Popenoe, recommends changing the method of allocating or "separating" non-traffic sensitive (NTS) subscriber plant and related costs between intraLATA toll and local exchange service in the same way we have changed the allocation of those costs between interLATA toll and local exchange service, namely by moving from allocation based on subscriber plant factor (SPF) to one based on subscriber line usage (SLU). He also recommends the direct assignment of WATS line costs to the closed end of WATS. Both these proposals were adopted for Pacific's intrastate interLATA tariffs in D.85-06-115.

Popenoe testified that the reasons for his SPF to SLU recommendation were "the very likely opening of the intraLATA market to competition sometime in the future....the undesirability of a large rate disparity between intraLATA and interLATA toll rates and the desirability of having a uniform separations methodology for administrative ease." (Exhibit 324, p. 5.) Popenoe emphasized that he does not recommend an automatic shift in rates among intraLATA categories to reflect these reduced indicated costs of intraLATA message toll and increased indicated costs of exchange service. Rather, he recommends that the separated earnings between these two categories be evaluated in each proceeding where rate design is in issue and that "the rate design reflect those earnings to the extent that appears appropriate at the time."

He added that the recommendation should be applied to all local exchange companies (LECs) and that these companies should apply the revised factors both for settlement purposes and for statement of earnings purposes. Popenoe acknowledged that his

proposal would reduce the settlements costs of the LECs, and therefore would reduce the settlements dollars they would be eligible to receive to recover those costs. However the net settlements effects would depend upon the actual intraLATA toll rate adjustments emanating from a review of these costs.

TURN views adoption of such a shift as facilitating "dramatically inequitable shifts of telecommunications costs onto local exchange telephone customers" and describes the SPF allocator as being "value-of-service based" while the SLU allocator is "value-less". TURN concludes that the choice of one over the other is merely a policy preference, and not a measure of "objective truth". For these reasons, and based on what it considers to be the weakness of Popenoe's reasons for making this proposal, TURN argues that the intraLATA SPF to SLU cost shift proposal should be rejected.

Pacific Bell supports the intraLATA SPF to SLU transition. Mr. Sullivan testified that a portion of the reduced intraLATA revenue requirement could be used as an offset against basic access rather than increasing rates to end users. His testimony apparently refers to the $12,078,000 in settlements which DRA and Pacific Bell agree Pacific Bell would save in the test year if we implemented the SPF to SLU proposal and an additional $24,418,000 in reduced reveue requirement which Pacific Bell would realize if the direct assignment of WATS proposal were implemented.

While we agree with TURN's observation that this is a proposal for a policy change and not necessarly a move from falsehood to "objective truth", and while we appreciate TURN's concern, we do not view this proposal as a passport to irresponsible rate making. Rather, we view it as a means of establishing a consistent cost policy and a means of more appropriately reflecting cost "causation". We agree with Popenoe's observation that adoption of such a policy should not herald an automatic rate shift among intraLATA cost categories. Shifts in

intraLATA rates must reflect many policy considerations, not the least of which is our objective of maintaining universal service.

As discussed in Section X.C, supra, the direct assignment of WATS line costs is not controversial. As we found in D.85-06-115, the WATS line is dedicated to a single use and so its costs should be directly assigned to that use. Furthermore WATS customers are high-volume users among the most likely to seek bypass alternatives. Reducing NTS cost allocation to WATS offers a reasonably focused response to the bypass problem.

The revenue requirement reductions adopted in this proceeding offer a unique opportunity for Pacific Bell to adjust cost allocations without producing disruptive local rate changes. Therefore, we will authorize the adoption of DRA's proposals for gradual transition from intraLATA SPF to SLU and for a flash cut direct assignment of closed end WATS line costs. We will adopt a seven year SPF to SLU transition so that it will coincide with the interLATA SPF to SLU transition. Under the circumstances it seems reasonable to allow the WATS direct assignment to coincide with the first year of the SPF to SLU phase-down. Further, in keeping with Popenoe's comments, we recognize that the propriety of continuing the SPF to SLU phase-down may need to be reevaluated from time to time for reasonableness. Therefore, we will provide for such reevaluation each time a participating carrier's rates are reviewed during the phase-down period.

2. Revenue Requirements Impacts

Pacific Bell and DRA agree that the revenue requirement impact of our adoption of this proposal is negative $12.078 million (Joint Exhibit 754, Table A, line 5). We hereby adopt that agreed-upon figure.

B. ICO High Cost Fund

According to Joint Exhibit 754 (Table A, line 15), Pacific Bell seeks $6.397 million in connection with the ICO High Cost Fund. However, on June 2, 1987, subsequent to preparation of

Joint Exhibit 754, the parties active in the rate design proceeding (including ICOs, except General Telephone) submitted a "Joint Supplemental brief - High Cost Fund Issues" recommending that this matter be handled via a billing mechanism rather than an incremental revenue requirement. While High Cost Fund issues will be discussed in more detail in the companion rate design decision, we merely note in this decision that we need no longer consider the $6.397 million incremental revenue requirement request, given the Joint Supplemental Brief recommendation.

C. ZUM Expansion

Zone Usage Measurement (ZUM) is a discounted toll rate plan which is applied in designated metropolitan areas. Pacific proposes to expand its ZUM rate plan on the periphery of the San Francisco - East Bay Extended Area to add twelve exchanges. In addition Pacific Bell proposes structural changes in the 39 exchange or district areas affected by this expansion. These changes include one consolidation, two divsions, relocation of 6 rate centers, and the elimination of two "district area" designations. The result of these changes will be that eight local routes will become non-local and seven non-local routes will become local. DRA supports Pacific Bell's ZUM expansion proposal. No other party takes a position on this issue. We agree that the criteria Pacific Bell used to determine the applicability of ZUM to these new areas was appropriate and the characteristics of the areas warrant ZUM expansion. We will authorize the adoption of Pacific Bell's proposed ZUM expansion.

The test year 1986 revenue effect of this ZUM expansion is a negative $15,088,000. (Joint Exhibit 754, Table A, line 10). We hereby adopt that agreed-upon figure.

D. Advice Letter Adjustments

D.86-01-026 provided as follows:

> "A number of advice letters were filed with rate changes, or for new services, during the pendency of these proceedings. While PacBell

> has estimated the incremental effect on revenues, staff has not completed its review. We will use PacBell's estimate for now, with the rates set today being subject to refund, but allow staff to present its analysis in connection with the next phase of these proceedings." (D.86-01-026, mimeo. p. 4a.)

DRA's Singh estimated the impact of advice letter filings on Pacific Bell's 1986 revenue requirement as a negative $45.5 million (Exhibit 614, p. 5). This compares to the negative $39.6 million recognized on an interim basis in D.86-01-026. The ($5.9) million difference, which Pacific Bell does not contest, is shown in Joint Exhibit 754 (Table A, line 12). We adopt the figure shown in the Joint Exhibit.

E. Settlement Impact of Surcharge Elimination from Pooling

Joint Exhibit 754 shows a positive revenue requirement of $11.545 million associated with the "settlement impact of surcharge elimination from billing" (Table A, line 8). While there is no dispute between Pacific Bell and DRA as to this amount, neither party provided any evidence at all as to what this issue entails or why the $11.545 million is reasonable. The issue was never briefed. It appeared for the first time in the Joint Exhibit submitted at the conclusion of evidentiary hearings. Based on this record, we have no basis for making a finding on the nature of the issue or the reasonableness of the associated revenue requirement. Therefore we cannot adopt it.

XII. Utilization

A. Background

In D.83-12-025, dated December 7, 1983, this Commission imposed upon Pacific Bell a penalty for underutilization of its central office and outside plant facilities in the form of a halving of the effective rate of return on the plant at issue. The penalty was originally $47.6 million, but was subsequently modified to the current $45.2 million. (D.84-06-111, mimeo. p. 116; D.84-04-104, D.84-07-067, mimeo. p. 2.) The basis for this penalty was this Commission's finding that:

> "Ratepayers and shareholders should share the risk of the underutilization, which occurred partly as a result of economic volatility, and partly as a result of poor management." (D.83-12-025, mimeo. p. 123.)

In D.84-06-111, the Commission provided that Pacific Bell could seek removal of the underutilization penalty upon an adequate showing prior to its next rate case application. Thereafter, on September 25, 1984, Pacific Bell filed A.84-09-065 seeking to remove the penalty and increase rates in an amount of approximately $13.8 million annually (this was the amount associated with the underutilization of outside plant). On March 25, 1985, the utility amended its application, seeking removal of $31.4 million (the penalty associated with underutilization of central office equipment). Thus, the total increase requested by the amended application equalled $45.2 million. In D.85-09-085, issued September 18, 1985, the Commission determined that the penalty would not be removed prior to hearing, providing that the issue should be heard in this proceeding. The Commission also ordered:

> "The present $45.2 million plant underutilization penalty shall be included in the interim calculation of test year 1986 revenue requirement on which interim rates to be authorized in Application (A) 85-01-034 will be based. The penalty shall be subject to

> removal, in whole or in part, retroactive to the effective date of those interim rates, based on the plant utilization evidence hereafter adduced in A.85-01-034." (D.85-09-085, Ordering Paragraph 4.)

Thus, the relevant date in terms of penalty removal appears to be March 5, 1986, the effective date of D.86-03-049, the order denying rehearing of the interim decision (D.86-01-026).

During Phase 2, two aspects of the plant utilization issue were explored. The first issue is whether the existing $45.2 million penalty should be lifted. This is to be determined by evidence as to whether the utility has met the plant utilization levels prescribed by D.83-12-025. Thus, the standard of review is purely whether or not the usage of this plant has exceeded the 91.5% (central office) and 67.6% (outside plant) minimum levels effectively imposed by the Commission in D.83-12-025. Pacific Bell acknowledges that it has the burden of proof on this issue.

The second issue explored in Phase 2 is prospective, and concerns the broad question of company planning methodology and procedures for plant investment. In this regard, we review a proposal for a forecast mechanism presented by DRA in Exhibits 568 and 569. We also review proposals of interested party California Bankers Clearing House Association (CBCHA) in the area of ready-to-serve plant.

The active parties during Phase 2 were Pacific Bell, DRA, and CBCHA. All three parties presented testimony and briefed the underutilization issue. CPIL's presentation on modernization/ utilization issues, as noted in Section XIV, infra, will be addressed in our separate modernization decision.

B. The Current Penalties

1. Pacific Bell's Position

Pacific Bell is requesting removal of the $31.4 million central office portion of the underutilization penalty, and a substantial lowering of the $13.8 million outside plant under-

utilization penalty. Its total recommendation, including a $1.9 million portion for additional underutilized outside plant, is $4.1 million. Pacific Bell indicated that it had achieved the threshold level for central office equipment utilization established in D.83-12-025. (91.5%)

Pacific Bell's view of its 1985 percent utilization was 92.3%. The outside auditor employed by DRA to verify Pacific Bell's central office utilization was Tele-Count Engineers, Inc. (TCE). TCE agreed, after reviewing all of the utility's central office switching entities, that the utility had reached the threshold level (91.61%). The difference between TCE and the utility amounted to approximately 85,000 access lines of capacity, including 8,200 access lines attributable to actual capacity errors and 77,000 access lines attributable to TCE's unwillingness to accept Pacific Bell's engineering guidelines. The main dispute involved switching machines whose capacity is limited by the amount of telephone numbers available. However, both Pacific Bell and TCE agree that the utility has exceeded the threshold level of 91.5%, and that the $31.4 million underutilization penalty relative to central office equipment should be removed. Further, Pacific Bell opposes adoption of TCE's suggested personal computer master file or institution of annual audits of central office equipment utilization, as suggested by TCE (TR. 12402), given the relatively small difference between TCE and Pacific Bell's calculated levels (91.61% vs. 92.3%). (We agree with Pacific Bell. Furthermore, DRA did not brief this issue, so it is unclear to us that it is still recommending these two proposals, in any event.)

Pacific Bell also argues that the $13.8 million outside plant facilities penalty should be lowered, back to March 5, 1986.

The 67.6% threshold level applicable to outside plant facilities, relates to Assigned Pair Loop Fill (APF). These are the assigned pairs divided by available pairs, where assigned pairs include both "working" and "idle assigned." More simply stated,

APF is the percentage of outside plant loops that are assigned, compared to those available for use. This measure of utilization, used in D.83-12-025, relates to a major part of the subscriber loop network--the copper feeder cables which are the first stage in the network of cables which carry telephone traffic from the wire center to the subscriber (Exhibit 568, Figure 6).

In 1983, Pacific Bell was using the COSMOS data base as a source of working pair data, while idle assigned and available pair information was still largely manually derived from other records. In 1983 Pacific Bell began initial trials of a new computer data base called LCRIS (Loop Cable Record Inventory System), based on basic cable data from LMOS (Loop Maintenance Operations System). LCRIS was created to support various engineering administrative tools that monitor the utilization levels of specific cable feeder routes. As LCRIS was implemented, Pacific Bell performed a substantial amount of data comparison between LCRIS and the pre-existing COSMOS and other data sources. This resulted in some inconsistencies. TCE audited a statistical sample of cable pairs, and found some further inconsistencies between the utility's manual and mechanized records of the assigned status of cable pairs, leading to a TCE-determined APF of 66.3% (1.6% below Pacific Bell's number). However, Pacific Bell agrees that the 66.3% APF is an accurate representation of its APF for the March/April 1986 time frame. Pacific Bell asserts that the 1.6% discrepancy found by TCE is related to the sheer volume and activity of the outside plant network (21 million cable pairs and over 7 million changes made in the status of these cable pairs in an average year; Exhibit 577, p. 8). Pacific Bell terms it "obvious" that such a volume of changes, along with human involvement, could produce some data inconsistencies. According to Pacific Bell, in no way do these inconsistencies validate TCE's argument that there should be an ongoing utilization audit, initially costing $4.5 million (Pacific Bell opening brief, p. 184).

While it does not argue for complete removal of the outside plant penalty, Pacific Bell does believe that the $13.8 million penalty is overstated and should be reduced. This is because the APF calculation involves only the feeder cable portion (i.e., that closest to the central office) of the outside plant investment, and only the growth-related portion at that (Exhibit 578, p. 5). APF does not capture distribution plant or public requirements plant ("public requirements" plant are facilities which must be placed due to street widenings or other government mandated projects). There are independent rationales supporting the investment in and usage requirements for distribution plant and public requirement plant. Furthermore, Pacific Bell believes that no overcapacity in such plant has been demonstrated, and it cannot therefore be presumed to be a proper part of the underutilization penalty. Nonetheless, DRA included investment in these facilities in computing the original $13.8 million penalty which the Commission adopted in D.83-12-025. Pacific Bell argues that such inclusion dramatically overstates the cost of a growth feeder pair and penalizes it for expenditures that DRA agreed were absolutely necessary (TR. 12506-12507). (Pacific Bell opening brief, pp. 185 to 186). Pacific Bell's witness Swenson argued that the true cost per growth feeder pair is approximately $280, versus the $1,660 figure used in the current $13.8 million outside plant penalty (Exhibit 578, pp. 6 to 7), and a consistent determination of an average number of underutilized pairs results in a calculation substantially lower than the $13.8 million of the original penalty.

2. DRA's Position

DRA believes that the underutilization penalty for outside plant should be increased by an additional $21.8 million, based on the results of the TCE study, which showed an increase in the audited utilization level to 66.3% for outside plant. The TCE audit also revealed the existence of a great many more excess pairs (Exhibit 571, Figure 5), in addition to the 106,500 excess pairs

upon which the present penalty is based, and this is the reason for DRA's additional penalty recommendation. Based upon the discrepancies among the various data bases used by Pacific Bell over time (COSMOS, LCRIS, LMOS), the TCE auditor also maintains that it is necessary to do a complete audit of the outside plant in order to have a verified base for the future, given mechanization of the various data bases (Exhibit 566, pp. 47 to 52). DRA asserts that even Pacific Bell's witness conceded that the TCE audit was useful and provided helpful information about the status of cable pairs (e.g., working, idle assigned, or vacant (TR. 17394)). Pacific Bell's witness further conceded that until the TCE audit, the utility had not done a statistical audit of that kind. Indeed, Pacific Bell had just started to establish parameters for the LCRIS file in 1984. Thus, while the utility asserted that it could pass the threshold of 67.6% prior to the TCE audit, it now concedes that at least as of the time the audit occurred, the correct level was actually 66.3%. (TR. 17394-17395.)

DRA proposes that the penalty be increased by $21.8 million to a level of $35.6 million (Exhibit 571, Figure 5). There is a dispute between DRA and Pacific Bell over the calculation of this additional penalty, as shown in the following table excerpted from the utility's reply brief (p. 19):

	D.83-12-025	DRA (Exh. 571, p. 2) (see Exh. 578, App. B, E)		PACIFIC (Exh. 578, App. E; Exh. 685 p. 15)	
		Existing Penalty	Additional Penalty	Existing Penalty	Additional Penalty
Net-to-Gross Multiplier	1.55	1.55	2.07	1.55	1.53
Unit Cost Per Available Pair	$1,660	$1,660	$1,190	$280	$280
Rate of Return to be Denied on Pairs	6.32%	6.32%	12.52%	6.32%	6.32%

In calculating its further penalty, DRA has used the net-to-gross multiplier of 2.07 and the rate of return (12.52%), adopted by the Commission in D.86-01-026. This contrasts with the 1.55 net-to-gross multiplier used in D.83-12-025. Further, DRA argues that all plant associated with the additional outside plant penalty should be excluded from rate base for rate of return purposes, based on the fact that but for DRA's insistence on an independent audit of the outside plant, the additional underutilized plant would never have been identified. DRA believes that its unit cost figure ($1,190) should be used because it is more consistent with the way the existing penalty was calculated (Pacific Bell wants a unit cost of $280 premised on growth feeder expenditures only (Exhibit 578, Appendix D)). Moreover, DRA submits that distribution plant expenditures should be included in the penalty, since this is necessary to balance out staff's use of average underutilized pairs instead of total underutilized pairs in the penalty calculation (TR. 12494-12513).

In addition, DRA submits that removal of this penalty should be contingent on the utility's paying for a study by a DRA-selected consulting firm. The consultant would make a study of

general practices and procedures which would promote cost effective utilization. This should be done in connection with the DRA modernization studies now under way. Since Pacific Bell has not directly voiced its opposition to this recommendation, the staff submits that the recommendation should be adopted.

Further, DRA submits that removal of the penalty should not be retroactive. Penalty removal should be authorized as of the date that an independent audit establishes that the utility has met the 67.6% outside utilization standard.

3. Pacific Bell's Response to the Recommended Additional Penalty

Pacific Bell argues that DRA's proposal to increase the present penalty from $13.8 million to $35.6 million is based on faulty reasoning. DRA's initial mistake is its use of a 1986 projection of total outside plant expenditures to compute the $1,190 penalty per alleged additional "underutilized" pairs (DRA's calculation divides an estimate of 1986 total outside plant expenditures by the estimated 1986 increase in feeder pairs available). DRA is using 1986 figures even though at the time it testified, 1986 was not even half completed. Obviously, in Pacific Bell's view, the bulk of any presently underutilized plant would have been placed well before 1986. Thus, it argues that DRA has failed to tie dollars spent and underutilized plant, and this is a major difference from the present penalty. Such an additional penalty should be based on the average cost for the years placed (1982 to 1985), in Pacific Bell's view.

Secondly, Pacific Bell criticizes DRA's inclusion of a number of items that are unrelated to feeder plant, (distribution plant, public requirement amounts, deteriorated plant rehabilitation expenditures, expenditures for pair gain equipment)--all of which erroneously exaggerate the penalty. Pacific Bell asserts that expenditures for growth feeder plant are less than 40% of total outside plant expenditures and that it is totally

inappropriate for DRA to seek to penalize all outside plant expenditures on the basis of its review of only one area--feeder plant.

As noted previously Pacific Bell criticizes DRA's increase of the net-to-gross multiplier from 1.55 to 2.07, which effectively increases the penalty.

Pacific Bell also criticizes DRA's change to the rate of return treatment, which it argues also inflates the penalty. DRA witness Heller proposes to disallow the entire rate of return on alleged additional underutilized plant (TR. 12516-12517), instead of only one-half as the Commission ordered in D.83-12-025. In Pacific Bell's view, the sole basis for DRA's proposal is an allegation of "poor management", although DRA's witness admitted that he had conducted no investigation of such management. Pacific Bell argues that such a penalty recommendation, with no underlying investigation or factual support, is completely inappropriate.

In any event, DRA's Heller agreed that Pacific Bell is taking steps to improve its utilization data bases through purification and implementation of a system called FACS (Facilities Assignment Control System) (TR. 12524). FACS promises to ultimately solve the current problem of Pacific Bell's partly mechanized, partly manual tracking of utilization information. Pacific Bell argues that it is unfair and inconsistent for DRA to nevertheless recommend a 100% rate of return penalty on the alleged additional underutilized outside plant when the record reflects Pacific Bell's ongoing efforts to improve its data bases.

4. <u>Discussion</u>

There is no disagreement that the central office underutilization penalty should be removed. DRA asserts that the removal date should be the date that the independent audit established the 91.5% criteria had been met (DRA opening brief, p. 150). However, D.86-03-049 contemplated removal as of March 5, 1986, and we will so order. The revenue requirements effects of

such removal, back to March 5, 1986, (i.e., the difference between $45.2 million and $13.8 million for the period March 5, 1986 forward) will be reflected in our Phase 2 rate design decision.

The primary area of contention is the outside plant underutilization penalty. Based on the audited 66.3% figure, both parties agree the record supports the continuation of a penalty for outside plant underutilization, and Pacific Bell agrees that some augmentation is appropriate (it calculates the additional revenue requirement for additional underutilized pairs at $1.9 million, rather than $21.8 million (Exhibit 685, p. 16)). The dispute is over how that penalty should be calculated ($35.6 million vs. $4.1 million). DRA correctly notes in its reply brief (page 128,) that Pacific Bell presented no study showing that utilization of distribution plant per se was now at an acceptable level. Pacific Bell has the burden of providing this record with adequate information to support a reduction of the mandated penalty, since that penalty relates to all outside plant, including distribution plant (D.83-12-025). Aside from its general arguments about the propriety of including distribution plant and public requirements plants (as D.83-12-025 did), it has not provided specific information regarding utilization levels of this plant to enable us to make a judgment on this issue. Therefore, we will continue the current $13.8 million existing penalty, without reduction.

The question of an additional penalty of $21.8 million (or $1.9 million) must be approached from a slightly different perspective, since it is DRA which has the obligation to present a sufficiently strong case to justify imposition of this additional penalty. As we have noted, arguments have been raised, but the record lacks specific studies regarding the utilization levels for the distribution plant, public requirements plant, etc. included in the calculation of the additional outside plant penalty. While our D.83-12-025 included such plant items based on our then judgment that the entire outside plant management area was

suspect, we feel that neither party has really definitively addressed the impacts of including these amounts on the question of "underutilization." Therefore, to include these impacts in the calculation of an additional penalty ($21.8 million or $1.9 million) would be inappropriate. We are also sympathetic to Pacific Bell's criticisms of the calculation of the additional penalty, in that we question the propriety of using the 2.07 net-to-gross multiplier, given our contrary treatment in D.83-12-025, and the entire rate of return. DRA's more stringent penalty proposal seems at odds with Pacific Bell's efforts to improve its ability to track utilization information. Thus, we are not persuaded that DRA has made its case that an additional penalty in the amount of $21.8 million is justifiably imposed for underutilization of outside plant. Neither will we impose a $1.9 million additional penalty, pursuant to Pacific Bell's calculation, given the state of the record.

Nonetheless, we are concerned that questions remain as a result of the TCE audit. We agree with DRA that removal of the existing $13.8 million penalty should be contingent on Pacific Bell paying for a study by a staff-selected consulting firm. We envision this penalty-removal study as involving two parts; an initial study and a primary audit. There is some dispute about whether the primary audit should be in form of a statistical audit or a full scale audit. We agree with DRA's Heller that a consultant should evaluate the utility's improvements in this area and the costs and benefits of a full scale audit prior to a decision to embark on a full-scale audit, since a statistical audit may suffice. We regard this evaluation as the initial study. (Exhibit 701, pages 5 to 6).

DRA recommends that the Commission order that such a consultant be hired by Pacific Bell, be paid for by Pacific Bell, but be selected and managed by staff. Because we are concerned that any such work (both the initial consultant effort and the

primary audit) be completely independent from Pacific Bell, it is absolutely necessary that the consultant and auditor be selected and managed by DRA. This is consistent with our past practice in handling this particular controversy. The question, given this Commission's lack of resources to pay for these major undertakings, is whether we should accede to DRA's request that Pacific Bell be ordered to pay for them. We have wrestled with this dilemma previously (e.g., D.85-09-085, mimeo. p. 11), and we resolved then not to formally require Pacific Bell to pay for the work of any staff consultant, based on the unique factual circumstances we faced in that proceeding. However, subsequently we found ourselves in the situation where Pacific Bell, having offered to pay for the consultant in order to expedite the penalty removal issue, thereafter balked at paying for additional efforts undertaken by the consultant during the rebuttal phase of the proceeding. This certainly did not assist the development of the record, and put the parties and the ALJ in an untenable position in their struggle to submit this proceeding. Thus DRA's request that we order Pacific Bell to pay for the consultant/auditor has some appeal, since we wish to avoid similar problems when the issue comes before us again. However, such an order is now unnecessary. We take official notice of the fact that an amendment to PU Code § 432(c)(3) was signed into law by the Governor on September 10, 1987 (Chap. 536, 1987 Stats.). This amendment to the code section covering reimbursement fees, permits the Commission to impose an additional fee on a telephone corporation for the costs of consultants and advisory services needed to assist in determining the reasonableness of its capital expenditures. The Commisson may adjust the fees within the class of telephone and telegraph corporations subject to such fees, so that the expenses for such consultants and advisory services are fully allocated to the telephone corporation in question. Using this mechanism, it will be possible to ensure that Pacific Bell pays for both the initial

consultant (who will review the costs and benefits of a full scale vs. statistical audit) and the primary audit, while both consultant and auditor are selected and managed by DRA.

Finally, there is no disagreement that the outside plant penalty should be lifted as of the date that the independent audit establishes that Pacific Bell has met the 67.6% standard. Therefore, we will allow Pacific Bell to file an application for removal of this penalty back to such date, based on the findings of the independent audit that Pacific Bell has met the 67.6% standard. The primary audit will be triggered by Pacific Bell's filing.

DRA has also recommended that the Commission order Pacific Bell to undertake a more general outside plant utilization study to be performed by a consultant selected by DRA. According to DRA:

> "*** such a consultant should be capable of evaluating the work methods and data flows that will be in use when Pacific Bell is converted to the FACS system, and should be able to recommend work procedures and computer procedures which would further optimize utilization and reduce costs. The consultant should also recommend data reporting procedures which will allow [DRA] to effectively monitor utilization in the new FACS environment. Mr. Dunn's recommendation of a full audit and regular audit updates would be one item which the consultant would evaluate." (Exhibit 701, pp. 5-6).

In accordance with the above request, we will order Pacific Bell to undertake such a general utilization level study, to be performed by a consultaing firm selected by DRA. If a dispute arises over payment of this consultant, we would expect DRA to take the necessary steps to invoke Section 432(c). We will require Pacific Bell to report the study results within six months of the effective date of this order, or within two months after

completion of the general study, so that DRA will have the ability it seeks to monitor utilization levels on a continuing basis. (Exhibit 570, Paragraph 14).

C. <u>DRA's Forecast Incentive</u>

1. <u>DRA's Recommendation</u>

For the future, DRA has essentially two recommendations unrelated to the specific question of the underutilization penalty. The first is its recommendation that the Commission propose to NARUC that consistent utilization measures be adopted in all states. In the last rate case, staff was able to compare Pacific Bell's utilization levels with utilization levels at other AT&T subsidiaries, since AT&T enforced uniformity. With divestiture, we have lost the ability to compare Pacific Bell's performance with the performance of comparable utilities in other states. This recommendation appears eminently reasonable, and is not opposed by Pacific Bell. We will adopt it.

The second recommendation is DRA witness Heller's proposal for an incentive/penalty formula to accomplish the goal of requiring Pacific Bell to bear more of the future risk of improper utilization. The proposal is an incentive designed to obtain better demand forecasts at the wire center level, rather than better utilization per se, since DRA believes a formula based on utilization could be subject to "gamesmanship" (Exhibit 569, p. 30).

The performance standard recommended by DRA takes the form of an incentive for Pacific Bell to improve its wire center level forecast of total access line gain. Access line gain is the major, though not the only, driver for plant additions. By improving its forecasts of access line gain, the utility should be able to lessen the incidence of underutilized plant.

DRA is not recommending that the Commission unilaterally impose the economic loss from missed forecasts on Pacific Bell. Rather, DRA recommends that the formula be revenue neutral,

keyed to Pacific Bell's current forecasting performance, rewarding improvements on current efforts, and penalizing performance which fall short of current efforts. DRA recommends that two-thirds of the economic gain from improved forecasting be allocated to ratepayers, and one-third to Pacific Bell. This would give the utility an incentive to improve on current efforts. DRA recommends that the economic loss from worse forecasts be allocated two-thirds to Pacific Bell, and one-third to ratepayers. This would make the utility absorb more of the cost of bad forecasts.

To make this change revenue neutral, DRA proposes the following: DRA will record the Spring forecasts of total access lines at each wire center for end of year, and end of the following year. Each Spring, along with the year's forecast, the utility will provide the actuals for the previous year. If the utility's total forecast error for the year is the same as it was on average during the 1983 to 1985 period, there will be no reward or penalty. If forecast error is less, the utility will be rewarded. If forecast error is greater, the utility will pay a penalty. DRA excludes Pacific Bell's performance before 1983 because its forecasting ability has improved since that time.

DRA proposes mean-absolute error of wire center forecasts as the measure of forecast error for use in the formula. Absolute error is simply the difference between the forecasted gain and the actual, with a positive sign. DRA also proposes to normalize the forecast error by the actual gain; thus, the mean absolute error is the sum of the absolute errors divided by the actual gain.

DRA has derived a standard of forecast error by which to compare Pacific Bell's future performance by analyzing data for years 1983 through 1985 which showed the sum of actual errors at the wire center level divided by actual gain to be 52.4% (Exhibit 569, figure 6). DRA proposes to round this figure to 50%. DRA also looked at the 1984 forecast of 1985 (Appendix E, Exhibit 568). DRA interprets this data as indicating that Pacific Bell's near

term forecast at the wire center level is typically off by 50%, either above or below. (Exhibit 568, p. 11.)

Based on work it has done with Pacific Bell and further estimates it has made in house, DRA proposes $30 million per year as a conservative estimate of increased revenue requirement resulting from forecast error. DRA suspects that the actual cost is considerably higher. DRA developed a model of the impact of forecast error on central office equipment expenditures, which estimated the increased revenue requirement at $21.4 million on an annual basis. Adding this figure to the $3.2 million increased revenue requirement resulting from a study done by Pacific Bell of estimated increased outside plant expenditures resulting from forecast error, the staff develops a sum of $24.6 million. It proposes a higher figure, $30 million, to take into account other forecast error impacts that were not taken into account in the models (such as early timing plant additions, and completely unnecessary expenditures).

These figures were calculated by estimating the present worth of expenditures (PWE) of capital expenditures which would be made with perfect forecasts, and the PWE of capital expenditures which would be made with Pacific Bell's typical forecast error. The difference between these two was then divided by the PWE of actual capital expenditures to get a percentage estimate for excess cost. This percentage is then applied to the dollar value of Pacific Bell's construction which is built to forecast to estimate the annual expenditures which would be avoided through perfect forecasting. (Exhibit 569, p. 12.)

DRA proposes that the following events take place to fulfill the first year of the formula's operation. Subsequent years would follow a similar pattern. First, Pacific Bell would turn over to staff its 1987 forecast of 1988 switched access line gain broken out by wire center no later than August 31, 1987. (These figures would obviously have to be adjusted given the date

of this decision). This should allow Pacific Bell sufficient time to complete its spring forecasting cycle. Pacific Bell would provide this in spread sheet form, with an accompanying full printout. As soon as available in 1989, Pacific Bell would submit to DRA its actual switched access line gain for 1988, again in spread sheet and printout form. Using the spread sheet, Pacific Bell would calculate the sum of the absolute wire center forecast errors and divide by the gain. If the error is less than 50%, then formula (a) would be used to determine the reward:

(a) Reward = (1/3) * $30 million * (1 - percent error/.5).

Thus the reward could not exceed $10 million. If the error is greater than 50%, then formula (b) would determine the penalty:

(b) Penalty = (2/3)* $30 million * (1 - percent error/.5),

Where the penalty shall be capped at $20 million. The cost of a poor forecast could of course, be far higher than $20 million. A graphical representation of the formula is found on the following page.

Forecast Rewa..d/Penalty

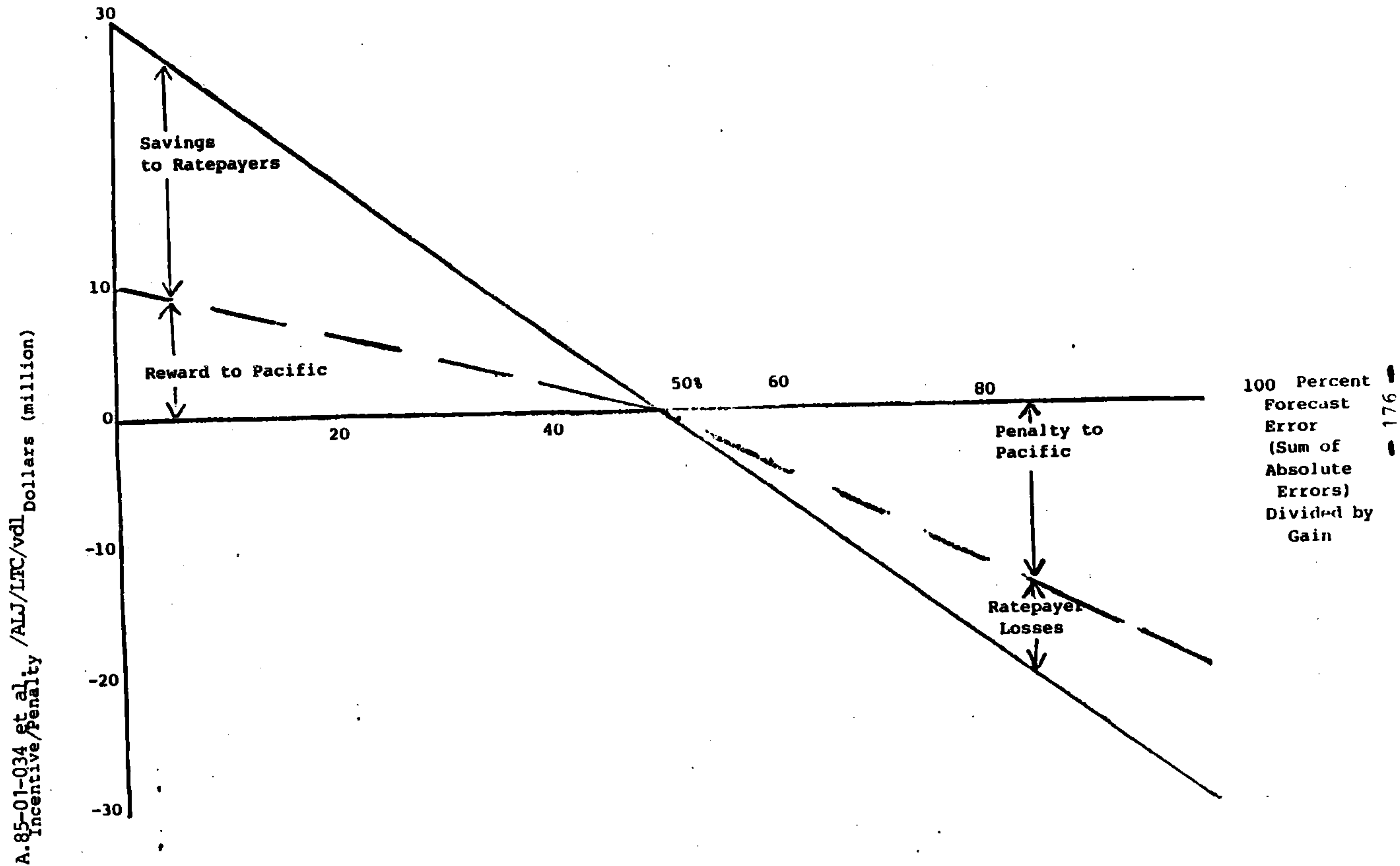

Figure 7

Staff would check Pacific Bell's calculations, also ensuring that the calculations used the forecasts provided in 1987 and that the spread sheet formulas were valid. Staff would also be empowered to ascertain whether the actual gain claimed by Pacific Bell in each wire center is accurate.

For convenience, application of the reward or penalty could be deferred to the next attrition or general rate case as an adjustment to the revenue requirement.

DRA believes that the importance of the incentive should not be measured simply by the dollar amount proposed. Forecasting is important not simply for determining the optimum time to add capacity additions, but it is also relevant to the decision to modernize.

2. Pacific Bell's Response

Pacific Bell believes that Heller's forecasting penalty/reward proposal is too narrowly focused and would lead to an unfair allocation of the risk of forecast deviations.

While Pacific Bell believes the proposal is aimed in the right direction, and commends Heller for the initiative he has shown in developing "his quite innovative incentive ratemaking proposal," the utility believes that the proposal is inappropriate for several reasons.

First, Pacific Bell believes the formula is inherently flawed because the penalty or reward depends on the actual access line gain, with no direct relation to actual dollars spent by the company. Thus, it believes the utility can possibly be penalized in one year and rewarded in the following year even though the forecast deviation is identical in both years.

Second, Pacific Bell believes the proposal incorrectly uses as a basis the annual spring forecast for all of Pacific Bell's 700-plus central offices, even though Heller agreed that only 200 of those offices had any equipment placed in 1985. Thus, the utility could potentially be penalized for forecasting errors

that have absolutely no ratepayer impact. Pacific believes this is violative of the legal standard the Commission should apply, i.e., whether imprudent actions have caused harm to ratepayer interests. It criticizes Heller's persistence despite his acknowledgement that Pacific Bell does "relook" forecasts before ordering equipment, and his admission that it could thus simultaneously adjust the timing and sizing of projects. Pacific Bell believes that there must be proof demonstrating that its forecasting process is erroneous before these risks are shifted to it, and asserts that such proof is noticeably lacking in this record.

Third, Pacific Bell argues that the proposal is unfairly biased in allocating two-thirds of any penalties, but only one-third of any rewards, to it. It notes that Heller admitted that this allocation was pure judgment (TR. 12545) and that a 50-50 split could provide just as much positive incentive.

Fourth, Pacific Bell believes that the worse inequity in the formula is the potential of a large swing in the economy (such as that which occurred in 1982), burdening the utility with a penalty over which it has no control. The utility believes that the Heller proposal effectively shifts the entire risk of the economy's unpredictability to the company and its shareholders. It asserts that any control it may have over forecasts is a far cry from control over either the economy or the impact of the economy on forecast accuracy.

Fifth, Pacific Bell argues that Heller has failed to account for possible duplication of penalties, since under his proposal Pacific Bell could be hit with both an underutilization penalty and a forecasting deviation penalty simultaneously--effectively penalizing Pacific Bell twice for the same event (Exhibit 583, pp. 11 and 12).

Pacific Bell believes that DRA has provided no cost/benefit analysis showing that the possible benefits of accuracy improvements outweigh the costs implicit in achieving these improvements.

The utility also criticizes the proposal as being too narrowly focused. Forecasting access lines is certainly important, but is not the sole determinant of the utility's business and its expenditures. Heller agreed that a broader incentive for efficiency that was fair, would be more desirable in theory (TR. 12561-62); the utility suggests that a preferable alternative would be the type of rate of return proposal explored in the testimony of witnesses Strahl and Byrkit in connection with productivity issues.

In addition, DRA's proposed penalty/reward formula based as it is on access line forecast accuracy has serious deficiencies when related to OSP capital deployment. It does not account for the utility's ability to track actual gain prior to ordering of equipment and could penalize Pacific Bell, even though Pacific Bell had done exactly the right job at the right time. It does not take into account the fact that the utility reinforces OSP cables on a route basis rather than a central office basis.

The utility also criticizes DRA's calculation of a $30 million cost of forecast deviations. It believes DRA has made some unwarranted assumptions in this area. For example, in the outside plant category, DRA's Heller assumed that for every job, the engineer made a 50% error time after time. He completely failed to account for normal course correction. In the area of central office cost of forecast deviations, DRA's Heller once again assumed a consistent year over year 50% overforecast. This assumption is a highly unlikely one in practice, as Pacific Bell's Petit noted.

Finally, Pacific Bell believes that DRA's Heller has used a totally unrealistic dollar amount in computing his central office cost of forecast deviations. Heller assumes that the particular

forecasts upon which he has chosen to base his proposal drive the total network growth category of expenditures, when actually these forecasts drive only a portion of the total central office exchange switching expenditures. For example, Heller assumes that the same forecasts of access line gain also are used to forecast traffic over the network and also drive all network expenditures including interoffice facilities. Pacific Bell asserts that this assumption fails to match reality. Furthermore, in estimating the cost of under-forecasts Heller merely assumed that one-fourth of the overcast figure was appropriate. To Pacific Bell, this illustrates the extreme assumptions underlying DRA's analysis, and underscores the fact that although well-intentioned, the proposed penalty/reward scheme is unsubstantiated on this record and not suitable for adoption.

3. Discussion

We commend DRA's Heller for attempting to address underutilization issues by attacking the source of the problem - forecasting at the wire center level - in a positive manner. While the incentive mechanism presented for our consideration is fraught with the usual problems inherent in forecasting, the proposal provides much food for thought.

Pacific Bell acknowledges the innovative nature of the mechanism, although it has many specific criticisms, as previously detailed. Our basic reaction is that some of those criticisms have merit, especially those that question the fairness of the mechanism (e.g., the 1/3, 2/3 allocation; the use of all 700+ central offices, even those which had no equipment placed during 1985). In addition, we would like to see additional analysis of the cost of forecast deviations to ensure that the mechanism, should we chose to adopt it, is fair.

For now, we will reject the proposal provisionally, because we have the overall impression that this is a good idea in need of a bit more fine tuning. However, we definitely wish to

revisit this issue. To that end, we will instruct Pacific Bell to include its own variation of this proposal as part of its application seeking removal of the $13.8 million outside plant penalty. Naturally, we expect DRA to actively participate in developing the record concerning any such forecast incentive, including presentation of its own proposal if it chooses to refine its own suggested mechanism to address the concerns expressed in this record. However, since the forecast mechanism deals with prospective utilization concerns, we do not condition removal of the existing OSP penalty on approval of such a mechanism. Nonetheless, we believe it appropriate, given the Phase 2 record, to hear the issues in one proceeding.

D. Dr. Selwyn's Proposals for Ready-To-Serve Plant

CBCHA presented an analysis of the present overall level of spare capacity, concluding that Pacific Bell had failed to justify the existence of more than one billion dollars of investment in spare outside plant. CBCHA asserts that the costs to Pacific Bell's ratepayers total nearly $350 million on an annual basis. CBCHA believes that Pacific Bell has not established that the existence of 5.5 million spare local loops (in addition to the spare loops necessary to accommodate churn and normal wear and tear) results in any net benefits to its ratepayers. Nor has the utility demonstrated that this spare plant (also termed "ready-to-serve," or RTS plant) reduces future construction costs or is somehow related to the maintenance of existing service order intervals.

In Pacific Bell's last general rate proceeding it was discovered that there existed a $2.6 billion gap between "bottoms-up" and "tops-down" loop investment (D.84-06-111, mimeo. p. 167). The Commission expressed concern about this disparity between the company's loop investment as directly measured in a bottoms-up cost study and as recorded on the company's books. In preparation for this rate proceeding, the utility performed a study of its outside

plant (the "ready-to-serve" or "RTS" study), and asserted that the disparity actually consisted of spare cable that is available to serve the needs of its customers as those needs grow over time, but which was not captured in its "bottoms-up" study. In addition, Pacific Bell determined that this spare plant should not be valued at $2.6 billion reflecting a fully allocated costing method, but rather at $1.038 billion, reflecting incremental costing principles. CBCHA does not take issue with the utility's cost methodology; its concern is that the underlying question of what is the appropriate level of RTS capacity has not been addressed.

Dr. Selwyn, testifying for CBCHA, noted that there are potential benefits in connection with the spare loop capacity. First, ratepayers could benefit through lower unit capacity costs brought about by pre-building capacity where incremental cost advantages are available. Second, a reduction in response time to service orders keyed to the existence of extra capacity might also benefit ratepayers. Selwyn concludes however, that it does not appear that ratepayers have obtained any substantial benefits in these areas.

First, he notes that ratepayers have not received benefits associated with pre-building of capacity to serve growth. While there is the possibility that savings might be realized through a pre-building of plant in anticipation of future demand, achievement of such cost savings is a function of the timing and the size of the anticipated future demand. If this demand does not materialize, the extra capacity and investment, which impose additional current costs on ratepayers, will have been unnecessary. If the demand is much larger than expected, new facilities may be required in any event, rendering the current spare plant superfluous. CBCHA believes this is a very real risk, attested to by DRA's sharp criticism of the utility's forecasting capabilities.

In addition, in CBCHA's view there are substantial current annual costs associated with the spare outside plant,

including maintenance and other overhead costs. For example, if a tree falls on a telephone aerial cable, all of the cable pair, both working and spare, will be repaired; furthermore, the repair cost will be higher because of the need to repair the spare loops.

Selwyn testified that Pacific Bell has experienced annual growth in working loops in the range of 400,000 to 700,000 pair over the past 15 years. If some of this gain were provided by RTS plant, the benefit could be calculated; unfortunately, Selwyn concludes that the utility always seems to add more loops to its inventory each year than are required to meet the growth in working loops (Exhibit 708, Table 3). Thus, on an aggregate level, he concludes that Pacific Bell never makes use of its RTS plant to serve growth and therefore never realizes the potential savings of its lower unit costs. It simply increases the level of RTS plant and the cost to ratepayers year after year.

Even assuming that 50% of the new working loops were taken from RTS plant, Selwyn concluded that their placement cost substantially exceeds Pacific Bell's calculation of embedded loop costs, and therefore certainly does not justify the present level of RTS investment (CBCHA initial brief, p. 8).

Selwyn's second contention is that the present level of RTS plant cannot be justified on the basis of fast response time to service order requests. There are two key points: First, what is the actual relationship between the level of spare capacity and the ability to respond to new service requests? Is there a relationship between the service order interval and the amount of spare capacity? Second, if there is such a relationship, one would need to evaluate the relative benefits and costs of improved or degraded response times. The question is whether ratepayers are better off with a longer response time, (i.e., if the service interval were dropped to one week) if this were associated with a reduction in RTS costs from $344 million to $200 million. In this case, Selwyn contends that Pacific Bell never established a

relationship between the level of RTS and service order intervals. Selwyn concluded that assigned pair fill (the inverse of the RTS plant level) and held service order data (for the period 1970 to 1986) demonstrate that the year in which held service orders peaked (1976) does not coincide with or immediately follow the peak level of assigned pair fill. Indeed, assigned pair fill was in excess of 74% in each of the years 1971 through 1974; it dropped to the 73.5% range in 1975 and 1976. The level of held orders moved up sharply from the 1975 level of 1,300 to the 1976 level of 2,900 and then moved down to 1,000 in 1977. Thus, Selwyn concludes that there is simply no basis to calculate ratepayer benefits associated with spare capacity as a function of service quality.

A dispute arose between CBCHA and Pacific Bell's witness Swenson about the role of churn in RTS levels. CBCHA believes that RTS plays a relatively minor role in serving churn (inward and outward customer movements), and that a far more important role is played by Idle Assigned Plant. The vast bulk of customer churn is accommodated through the use of Idle Assigned Plant and to a lesser extent defective pairs, with the role of RTS plant being relatively minor (CBCHA initial brief, p. 10).

According to CBCHA's analysis, 80% of churn would be served out of Idle Assigned Pair, based on the evidence of record, and the remaining 20% of churn would be satisfied out of defective pairs or through the RTS category. Thus, Pacific Bell's claim that the huge inventory of RTS plant is required to handle churn is patently absurd, in CBCHA's view.

In conclusion, CBCHA urges the Commission to order the development of procedures that will permit the parties to analyze the costs and benefits, if any, of RTS plant. It also urges that Pacific Bell be ordered to adopt consistent costing approaches in its service cost studies and its analysis of RTS plant for results of operations purposes. Finally, CBCHA urges the adoption of an accounting procedure which will ensure that

ratepayers are not burdened with excessive costs of RTS. Under this approach, the RTS investment would be placed in a special deferred capital account, outside rate base, in which ongoing interest and other operating costs would be capitalized and accumulated until specific pairs are from time-to-time removed from the RTS inventory and transferred to active in-service status. At that time the extant amount of capital that was accumulated for the investment, including capitalized interest and operating costs, would be transferred to Plant In Service and accorded standard ratemaking treatment (Exhibit 708, p. 57).

Pacific Bell argues that it has provided ample rationale on this record for the existence of RTS plant, specifically:

1. Ready-to-serve has allowed a 25% lowering of distribution services (OSP) staff, due to reduced needs for plant rearrangement (TR. 19551-52).

2. Ready-to-serve is created by outward movement of customers (customers disconnecting services). 80% of feeder cable pairs in the ready-to-serve category have at one time or another been working (TR. 19425).

3. Ready-to-serve is available mainly to accommodate churn rather than growth (TR. 19425-26). Distribution plant and conduit facilities in the streets allow Pacific Bell to avoid digging up streets and other improvements (TR. 19537-38).

4. Ready-to-serve has lowered customer-trouble reports due to constant churn that had been "wearing out the plant." (Exhibit 727, p. 27.)

5. Second lines in the last two blocks to residential and single line business premises allow ease of maintenance and replacement if the first primary line should become faulty and allow provision of a second access line should the customer so desire (TR. 19434-35, 19500).

6. Building cable in the ready-to-serve category provides for maximum potential usage in buildings and avoids having to break through floors of buildings after the building has been occupied, saving expense (TR. 19437-38, 19440-42).

7. Ready-to-serve is caused in part by the cable sized effect, when minimum size of cables must be placed (TR. 19443).

8. Ready-to-serve aids Pacific Bell's compliance with General Order 133 requirements for standard service provisioning time frames, specifically that provision defining a held order as one "held" for 30 days or longer (TR. 19484-85).

9. Ready-to-serve allows provision of service to newly constructed buildings and residences, during the period when those new buildings and residences are yet to be occupied (Exhibit 727, p. 5).

10. Ready-to-serve allows for changing customer requirements, when customers wish to change or otherwise upgrade their service (Exhibit 727).

Pacific Bell believes that CBCHA's annual carrying charge calculation of $344 million associated with ready-to-serve plant is overstated, in that it assigns to nonworking plant the costs for rearrangement of working facilities. While CBCHA argues that the utility has failed to estimate the net benefit from 5.5 million spare local loops, which it claims are in addition to loops required for churn and wear and tear, the utility claims that these 5.5 million pairs actually include those needed to account for customer churn, both inward and outward. In any event, the 5.5 million pairs relate only to the feeder aspect of ready-to-serve,

demonstrating in Pacific Bell's view, CBCHA's fundamental misunderstanding of the issue.

Pacific Bell also asserts that CBCHA errs in attributing great value to the pre-build idea. In Pacific Bell's view, CBCHA does not effectively counter Swenson's argument that it is far more expensive to not have enough spare capacity than it is to have too much. With too little, expensive excavation in streets and landscaping becomes necessary (Exhibit 727; TR. 195370-40). Pacific Bell argues that its methods balance these concerns so as to minimize plant costs.

Pacific Bell's Swenson also criticizes Selwyn's attempt to apply carrying charges for the entire ready-to-serve investment to statistics that only relate to the underground feeder cable investment. The ready-to-serve investment in underground feeder cable is $208 million, which is less than 20% of the total ready-to-serve investment. This misapplication of statistics from the ready-to-serve study produces inappropriate results, in Swenson's view (Pacific Bell's reply brief, pp. 142 to 143).

Pacific Bell also believes that CBCHA errs in attributing ready-to-serve plant to prompt service intervals for residential and single line business services. Pacific Bell counters that ready-to-serve benefits not only residential ratepayers but large business customers who are significant users of ready-to-serve plant as well (Pacific Bell reply brief, p. 144). Timely service provisioning is crucial to large customers. Further, Pacific Bell believes that CBCHA conveniently ignores the Commission's General Order 133 and 152 service requirements.

Pacific Bell strongly disputes CBCHA's position on churn, countering that ready-to-serve in fact plays a major role in satisfying customer churn demands. In Exhibit 730, Pacific Bell's Swenson indicates that about 40% of Pacific Bell's total churn is accommodated by ready-to-serve plant (TR. 19561; 19565-19571).

Thus, the facts demonstrate that ready to serve plant does indeed play a major role in this area.

Finally, Pacific Bell argues that CBCHA's requests that the Commission order a macro study of ready-to-serve costs and benefits, that it order Pacific Bell to be consistent in its approach to costs of service and its analysis of ready-to-serve, and that it adopt accounting procedures which would defer rate base treatment of ready-to-serve plant are all inappropriate.

We appreciate the efforts of CBCHA to shed light on the potential problems of excess ready-to-serve plant. We believe that the issue is not lightly dismissed, even though Pacific Bell has made a strong showing in opposition to Selwyn's recommendations. The disturbing fact remains that we should be concerned if there are excess levels of plant for which ratepayers receive no benefits. However, we believe that the macro study which CBCHA requests may not be the best way to get to the bottom of the situation for the reasons expressed by Pacific's Swenson at TR. 19553. The decisions that we would need to review are specific route-by-route decisions and as Pacific Bell points out, this kind of analysis is presently under way in DRA's SRI modernization audit and Pacific Bell's A.D. Little modernization audit. Thus, the kind of overall macro study CBCHA suggests appears to be premature at this point.

CBCHA's second request relative to adoption of consistent cost approaches also appears to be unnecessary given witness Scholl's testimony that Pacific Bell specifically assigns its ready-to-serve investment by the two methods required by the Commission in D.85-02-030: 1) in proportion to working and 2) in proportion to inward activity (TR. 19575). (Pacific Bell reply brief, pp. 154 to 155.)

Finally, Selwyn has suggested an accounting procedure which involves establishment of a deferred capital account for spare facilities, allowing investment and carrying charges not to

exceed the new construction costs to be removed from that account and added to rate base only if spare facilities are placed in service. Pacific Bell has raised the interesting point that the great preponderance of ready-to-serve plant has at one point or another been in use, thus making the request for special accounting procedures somewhat irrelevant. In addition, we are also concerned that the benefits of such a mechanism may be outweighed by the burden of cost. CBCHA has not addressed this question to our satisfaction.

For all the above reasons, we decline to adopt CBCHA's Phase 2 recommendation. Nonetheless, given the concern that such great levels of spare plant (as those identified by CBCHA) must be keyed to rational planning policies, we would not be adverse to revisiting this issue, including a review of the reasonableness of these levels, in the context of our review of the SRI and A.D. Little reports, subsequent to Phase 2.

XIII. Telesis Audit/Affiliate Relationships

A. Background

In the interim decision, D.86-01-026, we ordered DRA to complete its audit of Pacific Bell's affiliated relationships, while at the same time expressing great concern that Pacific Bell's active noncooperation had prevented completion of the audit during Phase 1. To place a price tag on our displeasure, we reduced Pacific Bell's gross revenue requirement by $4 million, pending completion and review of the audit in Phase 2. The DRA audit is now complete, and the auditors are recommending negative adjustments totalling $17,200,000 to the 1986 test-year revenue requirement.

For its part, Pacific Bell is recommending removal of the $4 million penalty, given completion of the audit.

Given the high stakes and the significant policy questions involved, it is not surprising that evidentiary hearings on the Telesis audit issues were most contentious. In addition to DRA and Pacific Bell, the Pacific Telesis Group (PTG), the PacTel Companies, San Diego Gas and Electric (SDG&E), and Southern California Gas Company (SoCal Gas) participated in developing the record on these issues. All active parties (with the exception of the two energy companies) presented testimony, and all active parties presented briefs.

B. The Commission's Historical Scrutiny of Affiliate Relationships

The Commission has historically scrutinized transactions between regulated utilities and affiliated corporations, and has in several cases imposed disallowances to account for excessive payments to unregulated affiliates. These actions have been premised on the need to carefully scrutinize affiliated transactions given the inherent lack of arms-length bargaining.

The California Supreme Court has held that for ratemaking purposes, the Commission may disallow excessive and unreasonable payments between affiliated corporations (Pacific Telephone and Telegraph Company v Public Utilities Commission (1965) 62 Cal 2d 634 at 659). In addition, the Commission may disregard the separate corporate entities established around the regulated enterprise and may regard the operations of the separate entities and the operations of the corporate enterprise as a whole (General Telephone of California v Public Utilities Commission (1983) 34 Cal 817; City of Los Angeles v Public Utilities Commission (1972) 7 Cal 3rd 331 at 344).

Prior to divestiture, the Commission concluded an extensive investigation into ratepayer contributions to the development of new equipment and software (intellectual properties) through license contract expenditures. At the conclusion of that investigation, the Commission established a procedure designed to determine which expenses would be allowed for ratemaking purposes. It delineated the following standard:

> "... we should ask the following question: Is the expenditure of direct and primary benefit to the ratepayers of the OTC (Operating Telephone Company)? If the answer is 'yes', the expenditure should be allowed (unless serious public policy reasons favor its disallowance) in spite of indirect or consequential value in other areas, including the possible development of products. Conversely, if an expenditure's purpose is shown not to be directly and primarily beneficial to the ratepayers, it should not be charged to them regardless to some secondary or consequential benefit to them. 'Benefiting the ratepayer' includes directly assisting the OTC in carrying out their fundamental responsibility of providing and maintaining a modern, reliable, telephone network. This, in turn, includes noninvestor 'related' support activities in such fields as administration, finance, etc., as well as the actual engineering of the network. It does not, in our opinion, include subsidizing the

> manufacturing arm of the Bell System in its development of competitive equipment. We express no opinion to the effect that Western Electric should not compete in the terminal equipment field but only that such competition should not be subsidized by the ratepayers through the license contract." (Pacific Telephone and Telegraph Company (1979) D.90362, 1 CPUC 2d 499.)

Following divestiture, Bellcore is now the research facility for the divested Regional Bell Operating Companies (RBOCs) established by the modified final judgment (MFJ). And the primary benefits test has been carried forward by this Commission on a post-divestiture basis in the interim decision (D.86-01-026, mimeo. p. 36).

C. DRA's Recommendations

1. Summary

DRA's negative $17.2 million adjustment is detailed as follows:

Description	Adjustment
Affiliate Payment	$ 14,000,000
Referral Fee	$ 1,527,000
Transferred Employee Fee	$ 1,270,000
Gain on Sale of Property	$ 403,000
Total	$ 17,200,000

In addition, DRA's auditors have recommended imposition of a number of requirements designed to strengthen regulatory oversight of transactions between Pacific Bell and the affiliated companies. These recommendations, excerpted from Exhibit 619, are as follows:

1. The DRA auditors should be informed of all organizational changes of the structure of Pacific Telesis Group.

2. Cost benefit studies should be performed in future property transactions involving the regulated Mobile Companies and its affiliates to allow the auditors to assess the merits of these affiliated transactions.

3. Rights to property should not be transferred to unregulated companies at less than an independently appraised fair value. The appraisals should take into consideration the relationship of the party exercising the option to Pacific Bell and the value of the property if Pacific Bell should vacate the property.

4. Notification of all future sales of Pacific Bell and Pacific Telesis Group Properties to PacTel Properties should be made to the auditors.

5. Movement of former Pacific Bell employees to and from affiliated companies should be tracked and activities should be reported to the Commission on an annual basis.

6. The PacTel Companies should provide quarterly reports on intercompany personnel movement to the auditors.

7. Pacific Telesis Group should reinstate Section 3 of "Pacific Telesis Group and Subsidiary Policy [for] Salaried Employees." Section 3 requires the PacTel Companies to track all intercompany movement.

8. Pacific Telesis Group should keep the auditors informed of all future guideline changes.

9. Bills from Pacific Bell to its affiliated companies should be paid directly to Pacific Bell rather than through PacTel Corporation in order to maintain a clear audit trail.

10. All transactions with Pacific Bell should be tracked through the affiliates' accounting system.

11. Pacific Bell and its affiliates should track all referrals from Pacific Bell to the affiliates. Totals should be reconciled on a monthly basis.

12. The affiliates should continue to pay Pacific Bell for the cost of the referrals on a transfer-priced basis so that Pacific Bell will recapture the total cost of providing the referrals.

13. Separate revenue accounts should be established by each affiliate to book revenue received from customers referred by Pacific Bell.

14. Pacific Bell and Communications should track and centrally file all customer RFP's, Pacific Bell's replies, and affiliate companies' replies to all sales contracts and RFPs in which the customer has chosen Communications as the vendor.

15. Pacific Telesis Group should develop guidelines and reporting requirements on intercompany personnel movement. Reports should be provided to the team quarterly and contain the information recommended by the auditors in Chapter 15 of Exhibit 619.

16. Pacific Bell should develop guidelines regarding release and disclosure of proprietary information and intelectual properties to the affiliates. The guidelines should be provided to the team for review prior to their implementation.

17. Pacific Bell and the PacTel Companies should track referrals made by Pacific Bell to its affiliates. Referrals should be tracked in accordance with the auditors' recommendations in Chapter 15, Exhibit 619.

18. Copies of all filings made by the affiliates with the FCC, DOJ, and Judge Greene, copies of all Opinions, Orders, and Rulings issued in regard to these filings and copies of all civil complaints filed against the nonregulated affiliates should

be provided to the auditors on an on-going basis.

19. PacTel Companies should maintain a subsidiary ledger for all inter-Company transactions. The ledger should be tested and reconciled to Pacific Bell's books by the Telesis Internal Auditors and the results of the audits should be provided to the DRA auditors.

20. Pacific Bell, Pacific Telesis Group, and the PacTel Companies must retain all internal and external correspondence under Pacific Bell's current policy until such time as the auditors and the companies determine a required retention period.

21. Pacific Bell shall develop a study on the market prices of its transfer priced services.

22. Continued CPUC surveillance of the affiliates is necessary.

In addition, DRA's auditors are recommending that certain of the so-called "SDO Conditions" imposed by D.86-03-090 in SDG&E's A.85-06-003 be imposed on Pacific Bell. These include the following SDO Conditions (DRA opening brief, p. 52; p. 135):

Condition 1.

The Commission shall have access, as it deemed necessary, to the books and records of SDO Parent Co., Inc., its affiliates and subsidiaries. Such books and records shall be produced within this State upon request by the Commission, its employees or its agents. Requests for production made by the Commission's employees or agents are deemed presumptively valid, material and relevant. Any objections to such requests shall be timely raised by SDG&E, SDO or its affiliates before the administrative law judge or assigned commissioner to the proceeding in which such objections arise. In making such an objection, respondents shall demonstrate that the request is not reasonably related to any issue properly before the Commission and, further, is not

reasonably calculated to result in the discovery of admissible evidence in the proceeding.

Condition 2.

SDO Parent Co. Inc. and each of its subsidiaries shall obtain the written agreement of their joint ventures to produce, upon request of the Commission or its employees or agents, the books and records of the joint venture as they may be related to transactions with SDG&E, said production to be in accordance with the provisions pertaining to the books and records of SDO and its subsidiaries.

Condition 5.

The officers and employees of SDO Parent Co., Inc., and its subsidiaries shall be available to appear and testify in Commission proceedings without subpoena.

Condition 6.

SDG&E shall furnish the Commission with:

a. The quarterly and annual financial statements of SDO Parent Co., Inc. including annual consolidated and consolidating balance sheets of SDO and its consolidated subsidiaries.

b. Annual statements concerning the nature of intercompany transactions concerning SDG&E and a description of the basis upon which cost allocation and transfer pricing have been established in these transactions.

c. The balance sheets of the nonconsolidated subsidiaries of SDO.

d. All periodic reports filed by SDO with the Securities and Exchange Commission.

Condition 7.

Within ninety (90) days following the close of its fiscal year, SDO Parent Co., Inc. shall provide the Commission with a detailed

statement of (a) the projected capital budgets of SDO and each of the next two years including estimated financing requirements and construction plans, and (b) sources of capital to be used in funding said capital budgets for the current year.

Condition 8.

SDG&E shall notify the Commission in writing within 30 days prior to any transfer to SDO Parent Co., Inc., or its affiliates of any asset or property exceeding a fair market value of $100,000, whether or not considered by the utility to be necessary or useful in the performance of its public utility obligations. This condition shall not include transfers of funds for investment under a cash management system.

Condition 9.

SDO Parent Co., Inc. shall avoid a diversion of management talent that would adversely affect SDG&E. SDG&E shall provide to the Commission annual reports identifying non-clerical personnel transferred from SDG&E to SDO or SDO's subsidiaries.

Condition 10.

Market, technological or similar data transferred, directly or indirectly, from SDG&E to a nonutility affiliate shall be made available to the public subject to the terms and conditions under which such data was made available to the nonutility affiliate.

Condition 11.

Neither SDO Parent Co., Inc. nor any of its subsidiaries shall contract to sell electric energy to SDG&E for resale by SDG&E.

DRA's auditors note that while this condition addresses electric energy, it is conceivable that a similar situation could arise for transmission services within the Pacific Telesis Group.

Condition 12.

SDO Parent Co., Inc. shall maintain a balanced capital structure in SDG&E, as determined to be reasonable by this Commission in SDG&E's most recent general rate case decision. SDG&E shall not permit retained earnings to be transferred to SDO where doing so would decrease its net equity ratio below that last adopted in a general rate proceeding.

Condition 13.

The dividend policy of SDG&E shall continue to be set by the SDG&E Board of Directors as though SDG&E were a comparable stand-alone utility company.

Condition 14.

SDG&E shall not guarantee the notes, debentures, debt obligations or other securities of SDO Parent Co., Inc. or any of SDO's subsidiaries without first obtaining the written consent of this Commission to do so.

Condition 15.

The capital requirements of the utility, as determined to be necessary to meet its obligation to serve, shall be given first priority by the Board of Directors of SDO Parent Co., Inc. and SDG&E.

Condition 16.

Without prior notice to the Commission, SDO Parent Co., Inc. shall not invest greater than 15% of its total capital assets in non-utility subsidiaries. The Commission may institute an investigation on its own motion to consider issues raised by the surpassing of the 15% level.

Condition 17.

SDO Parent Co., Inc. shall not sell, transfer or divest any of its subsidiary operations without first providing confidential notice to the Commission of the transaction. Said notice

> shall be provided not later than 45 days prior to the close of the transaction.

The DRA auditors have also recommended that the Commission institute further proceedings to examine other issues which were not adequately investigated or addressed, given Phase 2 time constraints. More specifically, the DRA auditors indicate that their audit is still not complete, given the need to further explore the important areas of joint ventures, strategic alliances, and research and development projects. In view of the importance of these outstanding issues, the auditors request the Commission not restore the $4 million penalty until successful completion of this further area of investigation. The auditors estimate that this endeavor will take an additional three months from the date of the Commission's Phase 2 decision.

At the conclusion of Phase 2 hearings, the DRA auditors raised the overall issue whether diversification has been (or will be) an overall benefit or detriment to ratepayers. According to the auditors:

> The principal advantage of diversification, in our opinion, is reduction of revenue requirements resulting from the sharing of costs with the affiliates. However, we believe the ratepayers are being forced to give up too much in benefits to the unregulated affiliates to achieve this cost reduction. The ratepayers have paid over $1 billion (and continue to pay over $100 million annually) for the development of technology which has been given, without charge, to the affiliates. The affiliates are using Pacific Bell management and technical resources to put this freely acquired intellectual property into marketable form and are thereby diverting revenue generating opportunities from Pacific Bell and the ratepayers to the stockholders. In light of this inequitable arrangement, the question should not be whether the team's proposed fees and royalties are justified but whether they go far enough. In our view, further hearings on this matter are warranted at a not too distant date for a more complete analysis of the risks

> and benefits of diversification and to determine whether additional remedial action, including the most drastic action of forced divestiture, is warranted. (Exhibit 734, p. 1-21.)

2. <u>The Affiliate Payment Proposal ($14 Million)</u>

The DRA auditors have keyed their recommended affiliate payment adjustment to D.86-03-090 (the SDO decision), wherein we approved conditionally SDG&E's request to diversify into unregulated operations via the creation of a holding company. Among the conditions we imposed in that decision was Condition Eighteen which provided for a system of benchmark payments following a subsequent investigation of that issue. The concept was in response to a suggestion by Utility Consumer Action Network (UCAN) for a royalty payment intended to capture intangible benefits that SDO and its affiliates would receive through their association with SDG&E. The DRA auditors urge us in this proceeding to recognize generic aspects of the SDO decision, arguing that D.86-03-090, through the payment benchmarks it delineates, provides a proper standard for determining how affiliate payments may be justified to compensate ratepayers for the intangible risks created and benefits conferred as a result of utility diversification.

The six benchmark factors are:

> 1. The business plans and organizational structure of the affiliate and its effects on the diversion of management attention;
>
> 2. The effects of the utility name and reputation on the affiliate business;
>
> 3. Whether cross-subsidies are likely to occur due to the nature of the affiliate business and the likelihood of intercompany transfers.

4. The ability of the affiliate to utilize proprietary information, utility assets, and expertise.

5. The ability to measure transactions' value by market tests or market proxies; and

6. The level of risk involved in the development and marketing of a new product or service. (D.86-03-090, mimeo. pp. 49-50.)

The DRA auditors point to the Commission's explicit recognition in the SDO decision that utility diversification does involve intangible benefits:

> "Other potential benefits may involve access to and use of utility expertise and resources. These assets, some of them intangible, were developed with ratepayers' support. If the utility is not compensated, these benefits to affiliates represent a cross-subsidy from utility ratepayers. We believe there will exist, in spite of all preventive measures, certain cross-subsidies that are not identified or adequately measured." (D.86-03-090, mimeo. p. 48.)

DRA's auditors argue that application of the SDO decision benchmarks would not interfere with the provisions of the consent decree divesting the Bell Operating Companies (BOCs) from AT&T, given the fact that the principal purpose of divestiture was to promote competition thereby creating conditions reducing costs and improving the quality and reliability of telephone service. Judge Greene at the time of divestiture noted that the diversion of energy, talent, capital and other resources by the RBOCs to pursue outside ventures on a substantial scale at this early stage had the potential for threatening that basic objective. (DRA opening brief p. 64.)

DRA also argues that application of the SDO decision principles will not conflict with the Computer II decision, since

the auditors' proposal does not seek in any fashion to subsidize local rates by using CPE earnings (DRA opening brief p. 65).

(a) Consideration of the Effects of Utility Diversification on the Diversion of Management Attention

According to the DRA auditors, this record supports the existence of serious problems in this area. First, the record has unearthed several instances of questionable activities involving loans and transfers of employees to affiliates (Exhibit 619, p. 13-1; Exhibit 137, p. 10-6, 10-7; Exhibit 619, p. 13-5; Exhibit 734, p. 4-19; Exhibit 619, p. 3-3; DRA Opening Brief pp. 68-69). These transfers are not trivial given the testimony of Professor Stigler, who testified on behalf of PTG as follows:

> "PacTel has tended not to enter new businesses without significant transfers of either personnel or other goods and services from Pacific Bell. I understand, for example, that with only one exception, each of the original presidents of the PacTel Companies has substantial experience in Pacific Bell. These data indicate that the PacTel Companies have entered business in which Pacific Bell's expertise...is of value." (Exhibit 656, p. 9.)

The Stigler testimony also indicates that in 1984, 100% of Pacific Telesis International's management staff came from Pacific Bell. While this percentage is somewhat smaller for other companies, and has itself decreased since startup, the evidence clearly shows how important Pacific Bell employees are to the PacTel Companies, especially during the critical start-up phase.

The DRA auditors discount Pacific Bell's argument that transfers help reduce force count and MIPP and SIPP requirements. In staff's view, the harm associated with losing the brightest and best people and retaining less qualified employees is far greater than any MIPP and SIPP costs saved (DRA opening brief, pp. 70-71).

DRA's auditors believe the record indicates that the employees who are being hired by the affiliated companies are those most highly qualified (Exhibit 619 p. 13-11).

The DRA auditors also dispute the implication developed on the record that Pacific Bell maintained a surplus employee list which was used by the PacTel Companies when hiring Pacific Bell employees. The record does not support the existence of such a surplus employee list, despite repeated data requests to Pacific Bell that one be produced.

One of the most serious problems in this whole area is the question of buy-back agreements. Exhibit 636, relating to Pacific Telesis International states:

> Resources will be provided to PTI for transfer pricing fee in most cases. In some cases the cost of transfer pricing may become cost-prohibitive to PTI. Assets Sales, the individual, the individual's home department, HDR, and PTI, will negotiate a solution that meets all parties' needs. Options that will be considered are as follows. ...Individual resigns from Pacific Bell and becomes PTI's employee. Buy-back to Pacific Bell provided at end of PTI project. Individual's service bridged.

As staff notes, under the above scenario, an affiliate would avoid costs associated with borrowing Pacific Bell employees and yet avoid a long-term commitment by virtue of the buy-back agreement. In DRA's view, this arrangement can only have one purpose: To exploit Pacific Bell resources at ratepayer expense. DRA argues that every indication on this record leads to the conclusion that these guidelines are current and in use. Buy-backs do occur and transfers have often been a result of loans to affiliates. DRA's position is that even if these particular guidelines (Exhibit 636) were not implemented in actual practice, the practice still occurred.

The risks of employee buy-back arrangements are two fold. First, these arrangements facilitate "phony" transfers designed to avoid loan costs to the affiliates. Second, they provide a safety net for transferred employees in the event the affiliate ventures don't pan out. It is DRA's position that buy-back agreements are not in Pacific Bell's best interests and that corporate policy should prohibit these agreements.

The DRA auditors also argue that structural separation does not mitigate the risks of diversion of management attention. DRA's auditors discovered that PTG allows officers and directors of Pacific Bell to be officers or directors of an affiliate or the holding company itself, and also allows non-Pacific Bell employees to regularly attend Pacific Bell Board and Corporate Committee meetings (Exhibit 734, pp. 4-1 to 4-4). DRA indicates that PTG was violating FCC Order 85-28 when it allowed officers of Pacific Bell also to be officers of the unregulated CPE subsidiary (DRA Opening Brief, pp. 76-77). FCC Order 85-28 specifically identified by name the employees who were dual officers of the CPE subsidiary and Pacific Bell, and ordered Pacific Telesis Group to discontinue this practice. DRA's Exhibit 639 demonstrates that as of the time of this investigation, these same officers were still dual officers. DRA believes that this impermissible intermingling of regulated and unregulated activities through constant oversight and direction has resulted in corporate decisions which have not benefited Pacific Bell and ratepayers. A prime example of this is the Bellcore waiver issue discussed subsequently.

DRA auditors believe that there are further examples of conflict of interest arising from allowing officers to have dual roles (e.g., the 2150 Webster Street purchase decision discussed subsequently). The auditors believe that Pacific Bell, not Telesis Financial Management Group, should have been evaluating the merits

of this purchase, since Financial Management's focus is the best interests of the corporation, with particular emphasis on the unregulated affiliates.

(b) Name and Reputation

The second of the six benchmark factors delineated in the SDO decision stresses the effects of utility name and reputation on the affiliate business (SDO decision, mimeo. p. 49). The DRA auditors have analyzed the extent to which the name and reputation of the utility might provide its affiliates with an initial advantage over their competitors and improve access to financing. The auditors have focused initially on the decision of the parent company to adopt names for its affiliates which start with "PacTel". They regard this as inextricably connected to Pacific Bell's predivestiture name, as evidenced by certain PTG publications:

> "It wasn't by accident that we chose the word telesis to denote what we're all about: Progress intelligently planned. Before divestiture, the symbol PacTel (Pac or Pac Tele) appeared on most national and international financial exchanges (Pacific Telephone was one of the few regional companies that had minority shareholders until an AT&T buyout in 1982). It takes years to build corporate identification and the corporation had a natural advantage in the financial community's familiarity with 'PacTel.' According to Don Guinn, Chairman and Chief Executive Officer of Pacific Telesis Group, 'we wanted to keep PacTel because that name has tremendous market power, but, at the same time, we didn't want to be known as Pacific Telephone because we provide far more than basic telephone Service.'
>
> "Today, Pacific Telesis Group is the name of a holding company with the number of subsidiaries both regulated and unregulated. It's a name easily identified within financial circles--a name which each of our companies can capitalize on and strengthen as they grow." (TR. 16944-6, Reference Item #20.)

The DRA auditors also presented several examples of affiliate advertising or proposals which explicitly or implicitly noted that affiliates had a heritage, experience, and financial strength which, in fact, could only be attributed to Pacific Bell. For example:

> "PTG was formed as a result of the divestiture of Pacific Telephone from the Bell System in January of 1984. It was the Bell System's largest operating company in the United States, enjoying a 78-year history of progressive telephony development and growth." (Exhibit 659, p. 3.)

There are additional examples of this type of reliance on the long-standing Pacific Telephone history in Exhibit 619, p. 14-3 - 14-11, Exhibits 653, 659, 660 through 668, Exhibit 734 pp. 5-23 and 5-24 and related attachments.

According to the auditors, "the massive use by the affiliates of their association with Pacific Bell has to exceed anything the Commission envisioned when it enunciated this factor, and verifies a concern which the Commission could only speak of in terms of potentialities in its SDO decision" (DRA opening brief, p. 82).

DRA auditors dismissed the claim that past Commission disallowances of institutional advertising mean that ratepayers have no investment in the name, reputation, and heritage of Pacific Bell. DRA auditors point to the testimony of PTG's own witness, Professor Stigler:

> "To the extent that reputation is possessed by Pacific Bell, that reputation is based primarily upon a staff of competent and dedicated workers and managers and a record of competent performance. That reputation is the by-product of the proper performance of Pacific Bell's duties as a public utility... (Exhibit 656, p. 16)." (DRA opening brief, p. 82.)

Additionally, the institutional advertising disallowance argument is wrong in the auditors' view because it ignores the fact

that such advertising is only a small portion of a regulated utility's advertising expenditures. In Phase 1 of this proceeding, only $18 million (29%) of a projected 1986 advertising expense of approximately $61 million was disallowed as institutional (Exhibit 734, p. 5-4).

(c) Likelihood of Cross-Subsidies

DRA believes that existing and proposed safeguards which are designed to prevent cross-subsidies in intercompany transactions are woefully inadequate.

The DRA audit revealed that the current transfer pricing system falls far short of its lofty objectives. The defects include unbilled services (Exhibit 619, pp. 3-4, 8-10, 9-4, 11-29, 14-20; Exhibit 671); late payments (Exhibit 619, pp. 4-6); and failure to use market-based pricing (Exhibit 619, p. 15-8). In the unbilled services category, the auditors submitted Exhibit 670, detailing 84 instances of suspected unbilled services. The DRA auditors acknowledged Pacific Bell is making improvements in this area, by imposing a late-payment finance charge (Exhibit 674) and clarifying its policy preference for market-based pricing (Exhibit 674). However, there are still major problems leading the auditors to conclude that the transfer pricing mechanism itself is no guarantee against cross-subsidies. There are several criticisms:

1. There is the human factor, which can never be 100% eliminated.

2. Pacific Bell's professed preference for market-based pricing is qualified by the conditions that such prices must be feasible to determine at a reasonable cost. The auditors are concerned that Pacific Bell will exploit these conditions to fully avoid implementing this policy shift.

3. Transfer pricing depends on transactions involving tangible items and the 10% surcharge cannot reasonably be argued to compensate ratepayers for intangible benefits flowing to the affiliates.

4. Pacific Bell has misled the Commission with its claim that it will always bill for the full cost of goods and services provided, not the incremental cost (TR. 19915-6). That is because goods and services comprise only one type of affiliate transaction category covered by the transfer pricing mechanism. Other categories include equipment, real property, leases, and intellectual properties (Exhibit 744, Attachment 3). Intellectual property is a special area of concern because it represents a resource upon which Pacific Bell spends over $100 million annually. Yet the guidelines of PTG state that sales of intellectual property by Pacific Bell to its affiliates are to be priced at the higher of the incremental cost of the transaction or market, where such properties have not been sold to third persons. This guideline provides no protection against exploitation of ratepayer funded properties.

5. The PTG guidelines provide that all intellectual properties owned by the holding company will be available to all affiliates free of charge, even if such properties were funded by the ratepayers as in the case of pre-divestiture intellectual property transferred to the holding company. DRA sees no justifiable purpose in the holding company holding any intellectual property. It views such ownership as a device to exploit ratepayer-funded property for the advantage of stockholders.

6. Finally, the PTG guidelines did not prevent Bellcore from granting the affiliates the right to use all the post-divestiture intellectual property held by Bellcore at ratepayer expense.

In the area of proprietary information guidelines, DRA found disturbing vagueness. For example, one of the definitions of proprietary information is "any information (which) the owner does

not wish to freely disclose." (Exhibit 740, p.10.) The auditors view this as an extremely vague standard.

In sum, the auditors conclude that the existing safeguards are plagued with loopholes, and are unenforced and willfully circumvented. The negative effects on the ratepayer are exacerbated by management's decision to resolve any conflicts between the ratepayer and the shareholder in favor of the latter. Furthermore, PTG has decided to seek synergistic benefits for the affiliates by entering lines of business that are closely related to those pursued by the regulated entity, thus making cross-subsidization all but inevitable.

(d) Ability to Utilize Proprietary Information, Assets, and Expertise

This fourth benchmark relates to the utility's possession of resources that would be helpful to the affiliates' lines of business, and its willingness to provide these resources to its affiliates.

The extent of the usefulness of this information of course is keyed to how closely related the affiliates' lines of business are to those of the utility. In this case, the relationship is very close indeed, as evidenced by Professor Stigler's testimony:

> "Firms typically have an advantage in starting new businesses only to the extent that some of their existing resources (including knowledge) can be applied effectively in new areas. Each of the PacTel Companies, for example, engages in a business in which Pacific Bell had considerable amount of prior experience--telecommunication, information, publishing, and property management." (Exhibit 654, p. 9.)

The auditors point to substantial evidence in this record that Pacific Bell has willingly provided its affiliates with proprietary information. The list includes: dual officers (Exhibit 639); interlocking directorates (Exhibit 639); access to

Pacific Bell's Strategic Technology Plan (Exhibit 673); allowing officers and directors of various affiliates to attend Pacific Bell Board of Directors Meetings (Exhibit 639 and 734, Attachment 4-B); provision of information regarding Bellcore waiver (Exhibits 657 and 658); information concerning customers (Exhibit 734, Attachment 4-E); business opportunities (Exhibit 734, Attachment 3-L); and equipment purchase plans (Exhibit 619, p. 10-6, para. 17).

However the auditors find most disturbing the transfer of technology and intellectual property. They conclude that almost all pre-divestiture intellectual property funded by ratepayers was transferred to Pacific Telesis and provided free of charge to the affiliates (Exhibit 734, pp. 2-1 - 2-4). As a consequence of this transfer, any revenues generated by these properties which prior to divestiture accrued to the benefit of ratepayers, will now accrue to the benefit of shareholders. The auditors believe that there has been no larger expropriation of ratepayer funded resources for the benefit of stockholders in the history of utility regulation in this state (DRA opening brief, p. 93).

The only remaining technology which Pacific Bell can exclusively call its own is that developed after divestiture and not through Bellcore. However, the auditors presented evidence indicating that even this new technology was made available to affiliates by Pacific Bell, and the record indicates that it may well have been provided gratis (DRA opening brief, pp. 93-94).

In addition, there is the area of expertise. The auditors believe that the record demonstrates that the affiliates rely extensively on Pacific Bell for expertise, and that they are able to lower their own overhead and personnel expense by relying on Pacific Bell to act as a short-term employment agency. (DRA opening brief, p. 95). The expertise that Pacific Bell makes available to its affiliates is often unique and available nowhere else. Examples include the Olympic expertise for Korea (Exhibit

669); the Olympic expertise for STET (Exhibit 734, pp. 2-5, 2-6); and Bellcore expertise for Spain (Exhibit 619, pp. 11-12).

(e) Ability to Value Transactions

The fifth benchmark factor relates to the ability to measure the value of a transaction by market tests or market proxies. The auditors have not considered, in developing their affiliate payment recommendation, any benefits flowing to affiliates which can be priced definitively on a per-transaction basis; rather they have focused on those benefits and risks which are not susceptible to such a definitive pricing mechanism. Included in these categories are name and reputation, access to proprietary information, access to assets, and access to expertise.

In particular, the auditors express concern about the transfer of intellectual property assets, and state they would have preferred to follow the SDO decision and carve out such transfers for separate consideration and pricing (SDO decision p. 51). However, due to the massive scale of transfers involved here, such analysis was not possible in the time available, assuming that such analysis is even possible (DRA opening brief, p. 97). The auditors note that the Commission was unwilling in the SDO case to accept SDG&E's market value estimate when only one intellectual property was involved, and ordered further hearings (SDO decision p. 51). Accordingly, the DRA auditors recommend on an interim basis that the transfers of intellectual properties be considered in conjunction with the affiliate payment determination (Exhibit 734, p. 2-4 as revised).

In the area of access to expertise, DRA auditors believe that careful scrutiny of the benefits of the transfer fee (10%) must be made. DRA's auditors proposed a 25% fee to cover cost savings associated with this transfer, but there are other benefits and risks of employee transfers which are difficult to detect or

evaluate, including: access to expertise not available elsewhere; transfers of proprietary knowledge possessed by the employee; brain drain.

(f) <u>Affiliate Riskiness</u>

This is the final benchmark which the Commission considered in its SDO decision, and again the DRA auditors submit its applicability. In particular, the auditors noted the impacts of fierce competition in the telecommunications market, exemplified by serious losses and layoffs at other utilities (e.g., U. S. West and AT&T). The auditors also cite recent developments involving PacTel Properties (which recently shed the brokerage portion of its business), PacTel Publishing (which closed its National Sales Division), and Pacific Telesis International (citing testimony of Mr. Long which concluded that the market for Bell proprietary systems or technology was not as strong as initially thought) (TR. 19964-19965). The auditors submit that the record demonstrates that Pacific Bell's affiliates are indeed engaged in risky enterprises and that this factor should be considered as supporting an affiliate payment recommendation.

(g) **Risk of Competition Between <u>Utility and Its Affiliates</u>**

The DRA auditors recommend an additional factor be added to the six which the Commission considered in the SDO decision:

> "The extent of possible competition between the utility and its affiliates and potential for the utility to divert opportunities to its affiliates." (DRA opening brief, p. 101).

The auditors point to three examples of such activities: Centrex vs. PBX; Pacific Bell Directory vs. PacTel Publishing; Bellcore vs. Pacific Telesis International (PTI).

Pacific Bell's Centrex and Premier service offerings compete with the PBX and key telephone systems sold by PacTel

InfoSystems. The auditors believe the evidence demonstrates that Pacific Bell perceives that it is losing customers and revenues as a result of referring customers to its affiliate (Exhibit 734, p. 3-17, Attachment 3K).

Pacific Bell Directory and PacTel Publishing were, at the time of the audit, both in the directory publishing business. While Pacific Bell Directory limited its service territory to California and Nevada, PacTel Publishing offered services in California in direct competition with Pacific Bell Directory (Exhibit 734, p. 3-4).

The auditors contend that Pacific Telesis International's primary business focus was, until recently, to internationally market PTG's proprietary information and technology (including Pacific Bell's share of same). However, at this same time Pacific Bell was precluded from foreign markets by restricitons imposed by the MFJ, as was Bellcore, its research and development affiliate. When Bellcore sought a waiver from the MFJ restrictions on behalf of its operating company owners, Pacific Bell passed this information along to PTI. (Exhibit 740, pp. 10-11.) Pacific Bell Witness Boro claimed that the decision to vote against Bellcore's waiver proposal was in Pacific Bell's best interests because:

> "1. Bellcore might enter lines of business in direct competition with Pacific Bell.
>
> "2. Pacific Bell would be exposed to high risk and costly international undertakings.
>
> "3. Possible antitrust exposure.
>
> "4. Marketing through Bellcore would limit Pacific Bell to 1/7th of the proceeds. (Exhibit 740, pp. 11-12)." (DRA opening brief, p. 102.)

The auditors counter all of these arguments. First, the concern that Bellcore would be competing against Pacific Bell in the foreign markets contradicts the PTG policy, which was aimed at

not creating any competition that did not already exist (TR 17138). Pacific Bell's entry into the foreign markets violated this policy because it would create competition with PTI which was already in those markets. In addition, the auditors cite a letter from Pacific Bell Marketing indicating that Pacific Bell did not intend to enter foreign markets (Exhibit 740, Attachment IV, p. 1-8).

The second concern regarding high risk and costly international undertakings is contradictory in the auditors' view. If the risks are too high for Bellcore, why weren't they also too high for Pacific Bell? In fact, Bellcore would be in a better position because it would be able to spread the risks among its seven owners.

As to the concern about antitrust exposure, the auditors contend that Pacific Bell's efforts to restrict competition from Bellcore already has substantial antitrust implications (Exhibit 740, Attachment IV, p. 1-8, para. 2).

Finally, the auditors view Pacific Bell's concern regarding limitation to 1/7th of the proceeds given its pro rata Bellcore participation, as having a greater ring of truth, but discount that concern since PTI was already in the market, and the more likely motive was to retain all the proceeds for PTI. (DRA opening brief p. 104.)

On a related, and perhaps more significant note, the auditors are concerned that Pacific Bell's negative attitude toward Bellcore and the other six owners (and in favor of its affiliate) may undermine Bellcore itself. This could be the greatest long-term risk, in the auditors' view.

(h) Other Risks to the Utility

The auditors recommend a second new factor in addition to the six SDO benchmark factors as follows:

> "Other Risks to the utility as a consequence of diversification." (DRA opening brief, p. 105.)

The DRA auditors recommend this factor because they have identified three specific risks:

> "1. Utility purchases from affiliates at prices above market value (Exhibit 734, pp. 1-4, 1-5, 4-27, 4-28; Attachment 4F).
>
> "2. Exposure of the utility to additional legal liabilities including antitrust liabilities (Exhibit 734, pp. 1-8 to 1-10; Exhibit 619, p. 9-11).
>
> "3. Utility usage of substandard affiliate products or services (Exhibit 619, p. 14-29; Exhibit 734, pp. 5-36, 5-38, 5-39; Exhibit 650, 1st page)." (DRA opening brief, p. 105.)

(i) <u>The Ratepayer Interest in Intangibles</u>

DRA believes the crucial question in this case is whether ratepayers are entitled to the intangible benefits traceable to utility economic assets. The DRA auditors believe that the Commission has already decided this issue in the SDO decision, as noted, but without significant discussion.

The first crucial point in analyzing this issue is a clarification: In the auditors' view, the issue does not involve a decision about ownership of the underlying economic assets. The auditors have never contended that the ratepayers own any asset. They <u>do</u> contend that the ratepayers have a beneficial interest in any asset or resource for which the ratepayers were put at risk. In support of this position, the auditors cite D.85-11-018, involving land sale issues:

> "Under our scheme of regulation, it is not true that the full risk of gain or loss lies with the entrepreneur or investor. The utility ratepayer bears a substantial portion of the risks of doing business that are ordinarily the responsibility of the entrepreneur. (D.85-11-018, mimeo. p. 13.)

> "Public utilities enjoy a unique status, shielded from financial calamity and disasters in order to ensure the on-going provision of utility services...[they] are not ordinary businesses; they enjoy a captive and dependent clientele." (D.85-11-018, mimeo. p. 14a.)

> "The risks of investment refer to which group would have borne the responsibility for the write-off of a capital asset. Since ratepayers...ordinarily bear that responsibility, they are generally entitled to the benefits of any capital gains accruing from a sale of utility assets..."(D.85-11-018, mimeo. p.18.)

The auditors note that the intangible benefits at issue in this case are traceable to utility assets or other expenditures for which the ratepayers are at risk. They posit that ratepayers are entitled to any benefits which flow from those assets or expenditures.

The auditors also note that if a utility is permitted to convert benefits attributable to utility assets to profits which lie outside the purview of the Commission's jurisdiction, this could make a mockery of the rate of return restrictions placed on the utility and could lead to a headlong rush by utilities into investments which could be exploited in this manner (DRA opening brief, p. 107).

(j) Arguments Supporting the Reasonableness of the 5% Royalty

In general terms, the auditors believe that the most difficult question posed by this case is how to determine a fair fee to compensate Pacific Bell and its ratepayers for the benefits and risks arising out of diversification. The benefit or cost of such intangible benefits defies direct evaluation, thus making the task that much more difficult. Nonetheless, the auditors believe they have demonstrated in this proceeding that diversification does lead to benefits flowing from the utility to its affiliates, and

that such benefits must be compensated. Not to do so in their view would inevitably lead to "a wholesale raid on utility resources with unacceptable consequences to the provision of utility services." (DRA opening brief p. 108.)

The auditors believe that a company-by-company approach should not be applied, despite the Commission's earlier determination that each affiliate should be evaluated separately in determining affiliate payment levels (SDO decision p. 49). The auditors believe that such an approach is impractical, in that diversification by PTG has led to the creation of numerous affiliated corporations which are constantly in a state of flux, not only organizationally, but also in terms of business pursuits (Exhibit 619, pp. 2-6, 2-7). Thus, a case-by-case approach would effectively impose too great a burden on the Commission and its staff. The auditors recommend that reviews be conducted as part of rate cases, where estimates could be made of the impacts of diversification as a whole, while recognizing that individual affiliates will be created, terminated, or otherwise changed during the period between test years. That is the approach that the auditors have employed in this case.

The auditors believe that Pacific Bell's test year revenue requirement should reflect its receipt of above-the-line income from its affiliates in an amount equal to 5% of the affiliates' estimated annual gross income. Since nonutility gross revenue is projected at $280 million, the 5% royalty produces a $14 million test year impact.

The auditors argue that the 5% payment is justified even if the company-by-company approach is used. They believe the record demonstrates that this level justifiably could be imposed on each affiliate, if viewed individually. This is due to the auditors' approach, which sought to develop a payment level applicable to affiliates receiving the least benefits and causing the least risks (TR. 16382 to 16384).

In formulating the 5% recommendation, the auditors maintain they employed the best market proxies available. To compensate for name, reputation, and other services, the auditors submit that the franchisor/franchisee relationship provides the closest analogy in the nonregulated business world to the relationship between Pacific Bell and its affiliates. The auditors reject the argument that nonregulated parent/subsidiary relationships are analogous, because such relationships are not arms-length, and affiliate transaction guidelines are (and must be) designed to ensure arms-length results.

The auditors' franchisee/franchisor analysis is a three-step process. First, the auditors analyzed information about the fastest growing 100 franchises in the United States, and discovered that 96% charged royalties on an on-going basis. The 84 which charged the royalty as a percent of gross revenues had fees ranging between 4% and 8%, and the auditors chose 5% as a conservative amount (Exhibit 619, pp. 14-47).

Having ascertained that royalties are routinely charged in the franchise environment, the auditors then conducted a franchisee study, randomly interviewing franchisor/franchisee consultants to determine the nature of the benefits for which royalties were being charged. The auditors believe that this study demonstrated that an established name and reputation has a definite value and is one of five key elements regularly charged for in a franchise fee (Exhibit 734, Chapter 5, Table 2).

The auditors conducted a third study involving the 100 fastest growing franchises using more recent information, and noticed that in a year's time, the range of fees had become .5% to 30%. The staff eliminated the high and low percentage fees, and the average range was determined to be 5.1%, with a median 6%. (Exhibit 734, Chapter 5.)

The auditors view the crucial issue to be whether the services provided by franchisors were more or less valuable than

the uncompensated benefits provided by Pacific Bell to its affiliates. In their view, Pacific Bell would be hard pressed to argue that its name is less valuable than that of the franchisors studied. Based on the business plans and promotional materials presented in this case, it is clear that Pacific Bell's affiliates place great value on this asset, particularly in foreign markets (Exhibit 619, p. 14-8; Reference Item 21; TR. 19769). In addition, the auditors believe that the grant of the right to use all the intellectual properties developed by Bellcore is "tantamount to Coca Cola granting a company in the soft drink business the right to use all of its soft drink formulas." (DRA opening brief pp. 112-113.) When the affiliates' access to all the managerial and technical expertise of Pacific Bell is considered, the auditors believe that the affiliates clearly are receiving far more from their relationship with Pacific Bell than a typical franchisee receives from a typical franchisor. Thus, the auditors believe that their 5% affiliate payment recommendation is very conservative.

The opposing parties' argument that use of Pacific Bell's intangible assets by the affiliates creates no additional cost to Pacific Bell, thus vitiating the need for an affiliate payment, is without merit in the auditors' view. The value of Pacific Bell's assets built up over a lengthy period of time, at a cost of billions of dollars to ratepayers, is the key focus. There is a significant amount of sunk cost, and the value is enormous. Given that reality, the appropriate test cannot be additional cost to Pacific Bell, but rather, what a third party would pay for the intangibles in question.

Finally, the auditors believe that the affiliate payment is avoidable. The auditors have already noted that the SDO decision recognized the possibility that affiliate payments might be zero if consideration of the benefit and risk factors indicated such a result. However, if PTG concludes that the affiliates could

not survive without triggering these factors, then it would be illogical for it to argue that the intangibles don't exist. The auditors note that no one said that the imposition of the affiliate payment would cause the affiliates to forego the benefits which give rise to the recommendation. The auditors conclude that apparently the affiliates would prefer to "go under" to giving up intangible benefits.

3. <u>The Employee Transfer Fee ($1,270,000)</u>

There is agreement on this record that costs associated with hiring, training, and developing Pacific Bell employees who transfer within the PTG family should be recovered. There is disagreement over the level of this fee and whether it should be a "one-way" or "two-way" assessment.

The DRA auditors recommend a 25% employee transfer fee based on rates used by professional employment consultants (i.e., "headhunters"). The auditors' research found that a majority of such fees range from 25% to 35% of employees' starting salaries (Exhibit 619, p. 13-6). The auditors have used the headhunters' fee because it is the best available market based fee closely approximating the costs associated with recruiting and hiring employees, and, perhaps more significantly, because the PacTel Companies avoid such costs when they hire Pacific Bell employees. The recommended fee is also designed to recover cost associated with Pacific Bell's training of transferred employees. As the auditors note, the record demonstrates that at least one affiliate (PacTel Mobile Companies) indicated that it felt there was no need to develop a formal training program for transferring employees because they had all received the necessary training at Pacific Bell (Exhibit 619, p. 13-6).

Pacific Bell argues that the employee transfer fee should be 10% based upon the markup on transfer priced services adopted in our interim decision (D.86-01-026, mimeo. p. 40). However, the DRA auditors note that this amount was designed to recoup sunk costs

associated with providing services to affiliates, rather than to recoup costs associated with the development of transferring employees. The auditors believe that a 10% fee would be "grossly inadequate" in these circumstances.

The auditors recommend that the employee transfer fee be charged only for employees transferring from Pacific Bell to its affiliates (a "one-way" fee). (The utility has argued that any fee should be applied to employees transferring both to and from Pacific Bell.) The auditors base their recommendation on the concept, discussed in the interim decision in the context of transfer pricing, that Pacific Bell as a subsidiary is ultimately "captive" to the wishes to PTG. In such a situation the regulator may recognize only a one-way markup to help ensure that ratepayers only benefit and are no worse off as a result of the corporate structure elected by PTG's shareholders. The auditors believe that this record amply demonstrates that Pacific Bell is "captive" to the wishes of its parent. Hundreds of Pacific Bell employees have transferred to the PacTel Companies and until now no attempt had been made by Pacific Bell to recover any costs associated with developing these employees.

Arguments have been made that there is no way to prevent utility employees from going to work for competitors of potential affiliate companies and therefore transfers of employees to affiliates should not be singled out for special treatment. The auditors believe the situations are vastly different for several reasons:

- There are buyback agreements between Pacific Bell and its affiliates (Exhibit 636).
- Pacific Bell loans employees to affiliates, not at market rates (Exhibit 734, p. 4-34).
- Pacific Bell transfers proprietary personnel information to its affiliates (Exhibit 734, p. 4-22, 4-23.)

- Pacific Bell employees transferring to affiliates continue service towards Pacific Telesis' Pension Plan. (Exhibit 619, p. 13-9.)

- Pacific Bell employees transferring to affiliates continue to participate in PTG stock option and savings plans (Exhibit 619, p. 13-9).

- Management has a say in transfers to affiliates. Management usually has no say in transfers to third parties.

- Pacific Bell provides recommendations to affiliates for employees that are highly qualified and are targetted as ready for promotion within Pacific Bell (Exhibit 619, p. 13-10).

- When a Pacific Bell employee transfers to an affiliate, Pacific Bell will buy out the employee's vacation. When an affiliate employee transfers to Pacific Bell, the vacation time is transferred to Pacific Bell (Exhibit 619, p. 13-10). All of these examples are cited at the DRA opening brief, pp. 117-118. All of these examples do not occur with third parties.

The auditors also focus on costs avoided. When the third party hires a Pacific Bell employee, it still pays hiring and recruiting costs, and it must also train the employee in technical and nontechnical areas. When a PacTel Company hires a Pacific Bell employee, these costs are avoided.

The auditors believe that the charges associated with a 25% fee are minimal, and that this fee will not eliminate transfers. However, if the PacTel Companies feel that they cannot afford to pay Pacific Bell for the cost of its employees, the PacTel Companies can simply elect to not hire such employees and incur the recruiting and training costs associated with hiring non-Pacific Bell employees.

4. The Referral Fee ($1,527,000)

The auditors have reviewed two types of referrals during this proceeding: First, dial-tone referrals (referrals for which Pacific Bell receives compensation and which are accomplished under formal procedures), and second, informal referrals (referrals for which Pacific Bell receives no compensation).

The recommendation for the test year with regard to PacTel InfoSystems leads to an adjustment to Pacific Bell's 1986 revenue requirement of $572,807 (Exhibit 619, p. 12-7). This recommendation is based upon the auditors' analysis of benefits which InfoSystems derives from Pacific Bell referrals, and is based on a percentage of the sales revenues resulting from those referrals. The purpose of the adjustment is to approximate a market value for the referrals. Analysis of company-provided data on referral revenue led the auditors to conclude that 13% of total sales revenue generated by referrals from Pacific Bell should be paid to Pacific Bell. Using InfoSystems' projected telemarketing center revenues for 1986 and applying the factor to project the percentage of those sales dollars that can be expected to result from Pacific Bell referrals in 1986 results in the $572,807 adjustment.

In addition to the dial-tone referrals, a number of affiliated companies are receiving informal referrals of various types. These matters have not been addressed in earlier portions of this rate case. For example, PacTel Connections is receiving referrals from Pacific Bell for Centrex Support Network Interfacing, and Information Transport Systems (ITS) and wiring. PacTel Connections is paying nothing to Pacific Bell for these referrals. The referral fee on PacTel Connections' projected 1986 revenues from informal referrals is $954,157 (Exhibit 619, pp. 12-7 to 12-9).

The auditors note that Pacific Bell appears to be investigating the issue of the propriety of charging for informal referrals to its unregulated affiliates. The reaction of the PacTel Companies and PTG was somewhat more problematic (DRA Opening Brief, p. 120). The DRA auditors believe that they have amply demonstrated that informal referrals, despite the absence of formal commitments by Pacific Bell, were regarded by both Pacific Bell and the PacTel Companies as commitments. In fact such referrals generated $5.6 million for the PacTel Companies during the year-ended April 30, 1986 (Exhibit 734, p. 3-6).

The auditors believe that the proper test for determining adequate compensation is whether Pacific Bell is maximizing its assets for the ratepayers benefit. On the other hand it notes that the PacTel Companies argue that the proper test is whether Pacific Bell is being fully compensated for all costs incurred. The auditors also note that this position contradicts the general policy statement of PTG (Exhibit 677) and Pacific Bell (Exhibit 674) that favor market based pricing where feasible. According to the auditors, once it is determined that Pacific Bell referrals should be market priced, the issue then becomes whether the auditors or Pacific Bell have provided the Commission with a more reasonable approximation of market price. None of the opposing parties, in DRA auditor's view have provided any evidence whatsoever that could lead to the conclusion that Pacific Bell's costs to provide referrals are a reasonable approximation of their value. During the year ended July 31, 1986, Pacific Bell provided referrals to PacTel InfoSystems costing Pacific Bell $44,220 but which generated $4,619,513 in revenues for the affiliate (Exhibit 734, Table 3-3). The auditors believe it is unreasonable to accept the view that $44,000 even comes close to the value of such a stream of revenues. The auditors argue that the value of the

referrals is better reflected in the profits earned as a result of the referrals, and even more conservatively, by the excess profits resulting from referrals in relation to nonreferral profits.

The auditors' methodology is based upon their belief that referrals would be of more value to the affiliates than to most outside vendors (DRA opening brief p. 124). Accordingly, the auditors regard their excess profit margin method, which focuses on the value of referrals to the affiliates, as superior to the market study focusing on nonaffiliates. In the absence of such a market study, this is the method they request the Commission to consider. A key to the staff method is that it compares profits made on referrals to nonreferral profits. It assumes that nonreferral profits represent what the affiliates can do by their own efforts, so the excess can only be attributable to the intrinsic value referrals, not in the efforts of the affiliates.

5. Land Sale Adjustments and Recommendations ($403,000)

2150 Webster Street is an office building being leased by Pacific Bell under a lease agreement which included a right of first refusal. When an outside party made an offer to purchase the building, Pacific Bell transferred its right to purchase the building to PacTel Properties which then exercised the right. Pacific Bell continues to lease the office space from Properties under the same terms as its previous lease agreement. The audit team submits that Pacific Bell's right to purchase the Webster Street Property has a monetary value, and that since this building was of interest to an outside party, PacTel Properties, Pacific Bell should have been compensated for the value of this right.

Essentially the selling price of 2150 Webster Street would be significantly higher but for the current lease held by Pacific Bell at 25% of the current market rate. Thus should Pacific Bell vacate the building, the sale price of the property would be much higher than what Properties purchased it for. Given

transfer of the right to purchase to an affiliated company, and the fact that the property's value would increase substantially if the property were vacated by Pacific Bell, the auditors recommend that Pacific Bell initiate a second consultant study to determine the value of Pacific Bell's right to purchase 2150 Webster Street.

In general terms, the auditors recommend for the future that such rights be transferred to unregulated companies at nothing less than an independently appraised fair value which must take into consideration the relationship of the party exercising the option to Pacific Bell and any inside information on tenancy of the property, or future value of the property, available directly or indirectly to the purchasing party.

The second issue relates to gains on sales of property once in rate base. On September 9, 1985, Pacific Bell sold the 420 Cowper Street building to PacTel Properties. The property had been transferred to Account 103.9 in May 1984 after being in rate base for approximately 32 years. The property's sales price was based on an appraised value of $2 million. At the time of the sale, book value was $585,338. The gain was booked to Accounts 360 and 171 in the amount of $952,590, and $446,596, respectively. (Exhibit 619, p. 5-6.) The auditors assert that the gain from the sale of real estate which has been in rate base should accrue to the ratepayers and not the shareholders. Therefore the team recommends that the gain of $1,202,590 be credited to Account 174, Other Deferred Credits. This amount includes a $250,000 correction made by the auditors at the time of hearings, because they determined that Pacific Bell had negotiated downward the property's value prior to selling to PacTel Properties. A new modernization cost figure calculated by an appraiser at Pacific Bell's request in March of 1985 was approximately $250,000 higher than that used in a preceding appraisal, and was based on improvements to the property that PacTel Properties felt were necessary (Exhibit 740). However Pacific Bell had its own architect evaluate the cost based on

PacTel Properties' list of necessary improvements and not independently. Pacific Bell's own authorization for sale states that the appraised value was negotiated downward by $250,000, indicating that this was a negotiated change and not a change of appraised value. The auditor's position is that the sale price of 420 Cowper Street should have been the $2,250,000 figure estimated originally by the appraiser. The resulting gain on the sale which should accrue to the ratepayers is $1,202,590. The DRA's opening brief also makes an additional argument regarding a January 1, 1988 Uniform Systems of Accounts (U.S.O.A.) recognition of above-the-line treatment of gains on sale of properties held in rate base (pp. 131-132).

6. <u>SDO Conditions</u>

As noted in the preceding summary section, the auditors are recommending that the majority of the SDO conditions be imposed on Pacific Telesis/Pacific Bell (Exhibit 734, p. 4-5). Although Conditions 19 and 20 were specific to the facts presented in the SDG&E proceeding and Conditions 6(e) would represent duplication of effort, the auditors believe most of the other conditions are of a generic nature and would provide the Commission with essential information in carrying out its regulatory oversight.

Although some of these conditions (Condition 1 and 7) are being met presently on a voluntary basis by Pacific Bell, the auditors believe that in an unsettled environment, management attitudes and policies regarding cooperation may also be subject to changes. The only answer is to create a more stable environment by mandating these conditions.

7. <u>Other Recommendations</u>

There are essentially three other recommendations. The first is imposition of guidelines. The second is retention of the $4 million penalty imposed in the interim decision. The third is document retention. These are discussed in order.

The DRA auditors have recommended a number of procedures to track intercompany personnel movement between Pacific Bell and its affiliates (Exhibit 619, Chapter 15). The auditors believe that the opposing parties have not presented any compelling evidence why such procedures should not be adopted.

The auditors have recommended a number of guidelines in the area of technology transfer. The auditors believe that the guidelines presented by Pacific Bell witness Boro, assertedly already in place, are insufficient.

In Exhibit 619 the auditors recommend a number of record-keeping requirements and tracking procedures be implemented for Pacific Bell referrals. Such procedures are presently lacking based on this record. The auditors maintain that in view of witness Long's testimony expressing PacTel Companies' intention to pay for bona fide customer referrals "as required by the FCC", it seems obvious that some type of mechanism should be put in place to track such referrals.

The auditors also recommend that the transfer pricing guidelines they recommend in Exhibit 619, Chapter 15 be adopted by the Commission. The auditors note that Pacific Bell has already made an attempt to do a study of the market price of some of its transfer price services, but shared that study with the staff only late in this proceeding, thus obviating any effective staff review of that study.

The auditors recommend, in view of the potential cross-subsidization which exists between affiliated companies, that it is imperative that better-than-adequate accounting guidelines be adopted by Pacific Bell's affiliates. The three accounting controls recommended by the auditors (Exhibit 619, p. 15-8; see also Items 19 and 20, Section C.1., supra), are designed to further this goal. In addition, the auditors recommend that certain

documents which come to the affiliated companies routinely (such as FCC and Department of Justice filings) should be provided to the DRA auditors on an ongoing basis.

The second major "Other Recommendation" is retention of the $4 million penalty imposed in the interim decision. This was a reduction in Pacific Bell's revenue requirement by $4 million to provide an incentive to the Pacific Telesis Group to fully cooperate with the Commission and its staff in the conduct of this audit. The auditors believe there is still much work to be done in the area of joint ventures, strategic lines, R&D projects, foreign partnerships, and other sensitive areas which have yet to be investigated. They submit it would be premature to restore the $4 million, especially in view of the tremendous problems they encountered in this proceeding just to obtain the information needed to do their work. Thus, the auditors recommend that the final disposition of the $4 million adjustment not be decided until after completion of the auditors' work regarding the affiliates. They estimate that this will take three months from the date the Commission's decision is rendered in this proceeding.

The final "Other Recommendation" relates to document retention. The auditors assert that their work was hampered because documents had not been retained by Pacific Bell or the PacTel Companies. They cite, for example, the review of the City of Palo Alto's RFP (Exhibit 734, p. 4-36). The auditors are also concerned about the files of key Pacific Telesis International employees, who have left that organization; these files may have been discarded (Exhibit 734, pp. 4-9 through 4-11). During discovery it appeared that PacTel Corporation indicated that the affiliates have no formal or informal document retention policy and that the disposition of documents is a discretionary matter. For this reason, the auditors have recommended:

> "Pacific Bell, Pacific Telesis, and the PacTel Companies must retain all internal and external correspondence under Pacific Bell's current

> policy until such time the Team and the Companies determine a required retention period (Exhibit 619, p. 15-8)." (DRA opening brief p. 142). The auditors recommend that Pacific Bell be ordered to cooperate with the staff in developing the record retention requirements.

D. Pacific Bell's Position

1. **Steps Taken to Ensure That Pacific Bell Receives Full Compensation for the Non-Tariffed Services It Provides Its Affiliates**

Pacific Bell's position is that its current transfer pricing procedures, reviewed during Phase 1 of this proceeding (at which time a 10% markup was added (D.86-01-026, mimeo. pp. 38-40)), are reasonable and ensure that it receives the full compensation for the non-tariffed services it provides to its affiliates. These procedures price services at fully loaded cost, including all direct and indirect costs, charges for return on investment, float, as well as the 10% markup for the embedded cost of Pacific Bell's expertise (D.86-01-026).

Pacific Bell states that it has refined these mechanisms as well. In the Fall of 1986 it retained Arthur Anderson & Co. to help develop a market based pricing structure for these non-tariffed services, in view of its earlier instituted policy charging affiliates the higher of either market-based price (where that price can be determined), or full cost (Exhibit 674, p. 8). Where market price is the higher of the two, Pacific Bell represents that it will bill on a retroactive basis for the additional recovery (Exhibit 677, pp. 10-11).

Pacific Bell states that it has also been developing a pricing schedule and guidelines for non-dial tone referral (Exhibit 674, p. 27; Exhibit 734, Attachments 3-F, 3-I). Once these guidelines are finalized it indicates that it will bill for those referrals on a going forward basis at the higher of either full cost or market price, and will also retroactively bill for past referrals (Exhibit 674, p. 8).

Third, Pacific Bell indicates it is working with DRA to develop competitive bidding procedures for the sale of real property which has been removed from rate base (Exhibit 674, p. 37). As a culmination of these efforts, Pacific Bell plans that these procedures will require competitive bidding whenever an affiliate is a prospective purchaser.

Fourth, Pacific Bell reports that the Pacific Telesis Group employment movement policy, modified May 1986, provides for a 10% transfer fee on the net movement between Pacific Bell and its affiliates (Exhibit 674, p. 29).

Fifth, Pacific Bell indicates it has established guidelines which it believes protect proprietary information, technology, and intellectual property from affiliates and non-affiliates alike (Exhibit 740, pp. 9-10). This is Standard Instruction ("S.I.") 178, which governs the handling of proprietary information. Under S.I. 178, Pacific Bell asserts that all employees who work with proprietary information are required to sign a non-disclosure statement which prohibits disclosure outside Pacific Bell. In addition, Pacific Bell notes that S.I. 178 calls for disciplinary action in appropriate circumstances.

Sixth, Pacific Bell believes it can provide software to its affiliates pursuant to the software waiver approved in April of 1986 (Exhibit 674, p. 16). However, it also believes that under its terms, no software can be made available to affiliates unless based on market price, and available to non-affiliates on like terms and conditions.

Finally, Pacific Bell asserts that it has enforced these guidelines, relying upon internal procedures and other standard controls including audits of its transfer pricing activity conducted by its internal group, an outside accounting firm, the FCC, and/or the California PUC (Exhibit 674, p. 22). The internal controls are set forth in S.I. 80 and are the procedures by which the Transfer Pricing Administrators conduct their annual review.

Pacific Bell asserts that these procedures recover the full benefit of non-tariffed services which it provides to its affiliates and protect against disclosure of proprietary information.

Pacific Bell maintains that it has effectively rebutted the following DRA's assertions: (i) that the affiliates are subsidized by benefits they receive, including tangible and intangible benefits; (ii) that the ratepayer has been harmed by the transfer of technology and intellectual property without compensation; (iii) that the ratepayer has been harmed by the election to forego business opportunities in favor of affiliates; and (iv) that the ratepayer has been harmed by any failure of the costing methodology to fully capture the benefit of services provided to affiliates. Pacific Bell believes that it has not subsidized its affiliates at all, and that it has not transferred technology and intellectual property to them. Finally Pacific Bell asserts that it has rebutted DRA allegations (i) that Bellcore violated the MFJ and the Plan of Reorganization by transferring to the affiliates intellectual property rights granted to Bellcore at divestiture (Exhibit 748, pp. 2-5), and (ii) that Bellcore, along with Pacific Telesis International, improperly transferred ratepayer technology to Spain under the TELEFONICA Proposal. (Exhibit 748, p. 7-13).

2. <u>Removal of the $4 Million Penalty</u>

Pacific Bell opposes the auditors' request that the Commission continue the $4 million penalty against Pacific Bell's revenue requirement until successful completion of a further audit. It contends that the penalty was to be removed once the audit of Pacific Bell's transactions with its affiliates was completed, which it believes is now the case. More importantly, Pacific Bell asserts that the record reflects that there has been full cooperation with the DRA auditors and there is no need to continue the penalty to protect against any refusal to provide proprietary information.

Pacific Bell also opposes DRA's request for a continuing audit on the grounds that exploration of research and development relationships involving unregulated non-affiliated firms would have a chilling effect on Pacific Bell's activities in these areas. Additionally, it maintains that the continuation of the audit to review transactions with third parties is beyond the scope of the audit that was ordered by the Commission which involved investigation of the affiliates and <u>their</u> relationship with Pacific Bell. Thus, Pacific Bell argues that the auditors are trying to extend the penalty on a new basis. In sum, Pacific Bell asserts that the auditors have not carried their burden of establishing that the $4 million penalty should be kept in place.

3. <u>Billing Procedures</u>

Pacific Bell counters the allegation that it has intentionally provided services to affiliates without charge as part of a pattern of cross-subsidization. It disputes several examples proffered by the DRA auditors, including one involving apparently unbilled services of an employee of Pacific Bell Directory, performed for one of the PacTel Companies. (Pacific Bell Opening Brief, pp. 275-276.) Pacific Bell argues that it has been monitoring transactions with its affiliates to ensure compliance with the transfer pricing procedures and that it has back billed for some services (Exhibit 674, p. 17). When the total record of transfer pricing transactions is compared to the 26 instances unearthed by the auditors where services were provided and no billing was submitted, Pacific Bell asserts that no reasonable person could conclude that there has been a pattern or practice of providing unbilled services.

4. <u>Transfer Pricing</u>

Pacific Bell indicates that it has been conducting a market price study with the assistance of Arthur Anderson & Co. (Reference Item 22). Furthermore, since May of 1986 it has clarified its intention to charge the higher of market price or

full cost for its services as soon as it completes this market price study (Exhibit 674, p. 8). Thus, it promises that, on a going-forward basis, the affiliates will pay the higher of either the cost as developed under the current guidelines or the market-based price.

Reference Item 22 is the preliminary report emanating from this study. DRA auditors initially asserted that no such study was being conducted (Exhibit 734, pp. 4-31-4-32), and ultimately they argued that the study results came too late. Pacific Bell acknowledges that the auditors may argue that the report should be disregarded because Pacific Bell did not confer with the auditors as the preliminary report recommends be done (Exhibit 747, p. 3), but considers its submission of the preliminary report in this proceeding an adequate response.

Further, it argues that determining marketing prices for its services is not an easy task, but that it has been diligently pursuing these efforts and will continue to do so, keeping the auditors involved in that effort (TR 19956-57).

5. The Affiliates Receive No Intangible Benefits Via Their Relationship With Pacific Bell

(a) Pacific Bell Asserts That It Is Not A Captive Buyer For The Goods of Its Affiliates

Pacific focuses on three specific examples cited by the auditors in support of their contention that Pacific Bell purchased products through PacTel Communications at prices higher than if it had gone directly to the manufacturer (Exhibit 734, Attachment 4-F). The first example relates to two Northern Telecom transactions, one involving purchase of Unity Series Telephones and the other the assignment to PacTel Communications of an IOS Agreement. Pacific Bell asserts that the auditors have not established that a purchase was even made of the Unity telephones nor the price at which PacTel Communications either could have, or

actually did, purchase the Unity phones. Pacific Bell belittles the auditors' reliance on statements made by Northern Telecom representatives regarding the price issue, asserting that they not even come close to establishing that a purchase was actually made nor the terms and conditions of such a purchase (Pacific Bell Opening Brief, pp. 285-286).

The second example was the IOS agreement. Since Pacific Bell was precluded by the MFJ from selling CPE after divestiture, the agreement with the CPE unit of Northern Telecom was for the sale of CPE, and Pacific Bell asserts that all that occurred in this particular instance was that this particular agreement was assigned to the deregulated entity that was selling this equipment (Pacific Bell Opening Brief, p. 286).

Third, the DRA auditors attack Pacific Bell's purchase of Virtual Micro Systems circuit boards. However, Pacific Bell asserts that the evidence actually demonstrates that the purchase of the boards occurred at a price negotiated directly with the manufacturer by Pacific Bell (Exhibit 734, Attachment 4-F).

Finally, Pacific Bell objects to the manner in which the auditors have painted the Pacific Bell purchasing decisions, countering that it purchases from either distributors or manufacturers dependent upon numerous factors, including but not exclusively, price. Such other factors include volume, storage, ability to deliver, etc.

It is appropriate to note at this point that the auditors have countered the above argument in the DRA Reply Brief (pp. 56-57). More specifically they focus on the Northern Telecom Unity Telephones, continuing in their assertion that Pacific Bell could have obtained lower prices for these telephones by purchasing directly from the manufacturer, rather than from the affiliate PacTel Communications. The auditors support their position with the statements of two Northern Telecom sales directors, and believe that Pacific Bell's responsive <u>argument</u> (that staff cannot prove

its point because Pacific Bell has never actually purchased anything directly from Northern Telecom with which to compare the purchase from PacTel Communications) is flawed. According to the auditors:

> "If Pacific Bell purchases a Toyota Truck from an affiliate for $20,000 and the staff presents statements from the manufacturer that they would have sold the same truck to Pacific Bell for $10,000, the burden of proof falls upon Pacific Bell to demonstrate that its decision to purchase the truck for $20,000 from the affiliate was reasonable. The staff cannot force Pacific Bell to purchase directly from the manufacturer (Northern Telecom in the instant case) in order to obtain a comparison of terms and conditions." (DRA Reply Brief, p. 57).

(b) Pacific Bell Asserts That It Is Not a Safety Net For the Affiliates' Failed Ventures

Pacific Bell addresses two staff arguments. The first relates to the Pacific Telesis International's Personnel Buyback Policy. The DRA auditors contend that five buyback letters (Exhibit 636) support the "safety net" argument. Pacific Bell also addresses the auditors' argument that Spectrum Services purchased computers with the intent to resell them to Pacific Bell if the business venture in question failed (Exhibit 619, p. 9-6; TR 15986-88).

Pacific Bell argues that the auditors have failed to carry their evidentiary burden that a personnel buyback policy exists. The figures submitted by the auditors indicate that over 750 people have transferred from Pacific Bell to the affiliates, but Pacific Bell argues that when this total is compared to five employees who had letters from Pacific Bell purportedly promising them that they could return at the end of their PacTel assignment, this amounts to less than one percent of the total applicable employee population. Pacific Bell also argues that the auditors

failed to go behind these documents to investigate personnel policies and practices. In addition, it notes that its witness Boro testified that the guidelines in issue were drafted, but never implemented (Exhibit 740, p. 9). Boro also testified that Pacific Bell does not have a buyback policy as the auditors suggest, but rather follows the Pacific Telesis Employee Movement Policy which indicates that assignments are generally career moves. Boro does acknowledge that this policy does not preclude execution of buyback agreements, however. Therefore, Pacific Bell asserts that it has rebutted the auditors' claim that the guidelines constitute established policy.

Additionally, Pacific Bell asserts that the auditors never went behind the letter which is Exhibit 633 to the principals or anyone else to investigate whether or not there was an agreement between Pacific Bell and PacTel Spectrum Services that Pacific Bell would buy the equipment if that became necessary. Pacific Bell asserts that Exhibit 633 does not itself state that Pacific will purchase the computers, and it has denied any such intent.

(c) The Personnel Movement Between Pacific Bell and Its Affiliates: No Ratepayer Harm

This area of controversy relates to DRA's claim that the affiliated companies avoid internal costs of training, developing, and hiring new employees, due to their relationship with Pacific Bell, and the auditors' recommendation that a 25% fee of the employee's annual salary be charged for transferred Pacific Bell employees.

First, Pacific asserts there is no direct evidence of ratepayer harm. While DRA claims that the ratepayer suffers because there is no recovery by Pacific Bell for costs associated with having trained these employees who move on, Pacific Bell counters by mentioning the force reduction currently underway, asserting that the transfer of employees to affiliates has aided

that process. Pacific Bell maintains that it has reduced its workforce by over 10,000 since divestiture, and many of these employees elected to participate in early retirement incentive programs (e.g., MIPP, SIPP), which were funded totally by shareholders because the Commission has disallowed these program expenses (D.86-01-026, Ordering Paragraph 9, mimeo. p. 214). Pacific Bell claims that the ability to allow employees to transfer to an affiliate provided another means for facilitating force reductions without the cost of MIPP.

Further, the Boro testimony criticized DRA for not citing a single example of harm to Pacific Bell in this instance. According to Pacific Bell, Boro also investigated and determined that there had been occasions when Pacific has refused to provide an employee whose services were requested by an affiliate (Exhibit 573, p. 11).

Pacific Bell further cites the testimony of Professor George Stigler of the University of Chicago (who testified on behalf of PTG in this proceeding), which strongly questions the value to an affiliate of having access to Pacific Bell's personnel. Stigler believes that the transfer of personnel in and of itself does not give a competitive advantage to an affiliate because the real yardstick is how the affiliate itself performs.

Finally, Pacific asserts there is no substantive difference between an employee moving from Pacific to an affiliate and the same employee moving from Pacific Bell to IBM, or Rolm, AT&T, NYNEX, or U.S. Sprint. No distinction exists, in its view, by virtue of the fact that some employee benefits may transfer with the employee to the affiliate.

(d) Pacific Bell Asserts It Is Not Harmed By Its Relationships With Its Affiliates

Pacific Bell addressed several DRA contentions.

The first contention relates to the allegation of harm when PacTel Connection, a subsidiary of PacTel Communications filed a response to the City of Palo Alto RFP in conjunction with Pacific Bell and then pulled out at the last minute, allegedly leaving Pacific Bell in the lurch. DRA also contends that the utility's reputation and service were harmed by PacTel Communications' failure to perform on other jobs. Pacific Bell believes it has demonstrated that no harm resulted from these events. It views its joint bid with PacTel Connection on the City of Palo Alto RFP as totally proper. Pacific Bell roundly criticizes the survey conducted by DRA of potential respondents to the City of Palo Alto RFP (Exhibit 625) (Pacific Bell Opening Brief, p. 297-299). It concludes that DRA's affirmative showing is lacking, and that its survey methodology is infirm. On the other hand, Pacific Bell believes that it demonstrated that the City of Palo Alto requested Pacific Bell to bid for the project with PacTel Connection, and that the utility ventured with its affiliate only after the City had requested this by amending its RFP.

The DRA auditors also contended that the utility had been harmed by its referrals to the Telemarketing Center in PacTel Communications because the latter has "unhooked" Pacific Bell's sales. (Exhibit 734, pp. 3-16 to 3-17). Pacific Bell counters that the auditors have not advanced any documented instance of the unhooking of an actual sale. Pacific Bell asserts that it cannot otherwise respond to DRA's general allegations on this issue.

Pacific Bell next responds to the DRA claim that there has been a diversion of corporate opportunities from Pacific Bell Directory, Pacific Bell's wholly owned subsidiary, to PacTel Publishing. The auditors claim that corporate policy restricted

Directory to California and Nevada, and then permitted Publishing to occupy all other areas. In addition, the auditors claim that PacTel Publishing has actually infringed on Directory's territory by publishing certain specialty guides in the State of California. Pacific Bell believes that the staff's investigation was once again too limited, in that the auditor did not interview the principals at Pacific Bell Directory to verify the meaning of certain meeting minutes of the Pacific Telesis Policy Group. Witness Boro testified that neither Pacific Bell Directory nor Pacific Bell had adopted a policy restricting Pacific Bell Directory.

However, even if the auditors' claim is true, Pacific Bell asserts that ratepayers are nonetheless protected, since they do not pay for the losses associated with these new ventures.

Next, as to the DRA claim that PacTel Publishing infringes on the territory of Pacific Bell Directory and that Directory should receive some compensation for this infringement, Boro notes that the unregulated Pacific Bell Directory has no exclusive rights to any territory but must compete with many companies in its area. He asserts that since Pacific Bell Directory does not ask the third parties with whom it competes for a fee for publishing directories in its area, it would be inconsistent for Pacific Bell Directory to make such a request of PacTel Publishing (TR 19933). Also, PacTel Publishing and Pacific Bell Directory offer different products, with the former aiming at vertical markets (e.g., hotel/motel industry, architects, etc.), while the latter focuses on markets in California. All things considered, Pacific Bell believes that PacTel Publishing has not infringed on Pacific Bell Directory's area or line of business as the auditors contend.

Pacific Bell next addresses the DRA allegation that corporate opportunities have been diverted to PacTel Properties. This relates to the 2150 Webster Street property "right of first refusal" transferred to PacTel Properties, and DRA's claims that

the gain on sale of the 420 Cowper Street property should have been booked to the ratepayers. Pacific Bell believes that the 2150 Webster Street issue is "old hat", since it was fully litigated during Phase 1. Nonetheless, it asserts that the record is clear that through the advice of an independent appraiser, it determined that the right of first refusal on this property had no ascertainable value, "fully justifying its transfer to PacTel Properties without compensation" (Pacific Bell Opening Brief, p. 305).

On the issue of 420 Cowper Street, Pacific Bell asserts that the property was surplus properly held in Account 103. It notes that DRA's reliance upon D.86-01-026 is misplaced since the 420 Cowper Street sale occurred prior to issuance of that decision. It regards any attempt to carry back the effect of that ruling to reach the 420 Cowper Street transaction as retroactive ratemaking.

With regard to DRA's claim that the Old Altamont Road property was sold at under value, Mr. Boro asserted that the property had been appraised in September 1985 for its highest and best use consistent with its zoning (agricultural), and that that appraisal had come in at $23,500. The property was sold for $80,000 in October 1985. Boro also noted that although the appraiser did not consider that the land had been considered for use as a microwave and/or windmill site at one time, the appraiser discounted these alternatives as having no value. DRA however points out that the PacTel Properties has since leased the Old Altamont Road property to AT&T at a profit. However, Pacific Bell retorts that it is not in the business of leasing, preferring instead to leave such activity to real estate firms like PacTel Properties and concentrate on providing franchised local telephone service. Therefore, it believes this DRA claim has no merit, because the primary concern should be whether Pacific Bell recovered its investment and optimized its contribution from the property--facts which the record clearly demonstrates in its view.

Finally, as to the DRA contention that the utility should have sold the property at 4959 Sepulveda Avenue at under market value but did not because Properties wanted the parcel, Pacific Bell professes to be "totally at a loss." (Pacific Bell Opening Brief, p. 307). Pacific Bell indicates it was not interested in selling the property because it needed it to run its business (Exhibit 637, TR 16192).

(e) <u>No Technology Transfer</u>

Pacific Bell asserts that the record is barren of any evidence that would support the DRA auditors' claim that it cross-subsidizes its affiliates by transferring ratepayer-funded technology free of charge. According to Pacific Bell, the evidence that the auditors rely upon consists of passages from proposals made by the utilities' affiliates to prospective customers. The utility submits that the proposal language does not establish a transfer of technology or the intent or attempt to transfer technology.

Pacific Bell first focuses on the auditors' premise that non-compensated usage of the utility's name and reputation harms ratepayers. It believes that the ratepayers have not paid for name and reputation, that name and reputation are not assets included in rate base, and that the right to use the Bell name was assigned to the seven regional holding companies at divestiture. Further, it argues that expenses normally associated with building name and reputation are institutional advertising, traditionally disallowed by this Commission. Pacific asserts that the ratepayers receive their quid pro quo for paying for utility service when they receive that service at levels deemed appropriate by this Commission.

Pacific also asserts that the extent of the value of name and reputation in the marketplace is also problematical, citing Professor Stigler's testimony that the value of the reputation might be that the PacTel Company would be able to get its foot in the door at a lower cost than would otherwise pertain, but that

this value would vanish as soon as consumers have had enough experience with the enterprise to judge its actual performance. (TR 16883-85.)

Pacific Bell then counters point by point the DRA auditors' complaint that the language contained in certain PTI proposals evidences an actual transfer of technology. First the auditors point to the Venuzualian Network Administration Proposal ("VNAP") to highlight their concern about the use of Pacific Bell's name. However, Pacific Bell counters that PTI is only "promising to deliver" a Network Administration System that is similar to Pacific Bell's. More importantly in Pacific Bell's view, the PTI contact person who discussed this proposal with DRA indicated that PTI had no intention of turning to Pacific Bell for services it would need to perform under this proposal. Finally Pacific Bell believes the issue is resolved, since no technology transfer occurred because the PTI venture was unsuccessful.

The second instance is the Indonesian Outside Plant Proposal, where the auditors assert that Pacific Bell's expertise in outside plant was being offered. Again, Pacific Bell asserts that the PTI subject matter expert stated that PTI would not use any software systems from Pacific Bell since it could do everything it needed to do by using off-the-shelf commercially available hardware and manual methods. Pacific Bell believes the auditors apparently rejected this explanation. Pacific Bell also notes that the PTI proposal was unsuccessful.

Third, DRA claims that Bellcore through PTI, transferred to TELEFONICA "the premier R&D know-how and experience at Bellcore which was developed at the ratepayers' expense" (Exhibit H-619, p. 11-11). Pacific Bell counters that Bellcore provided no more than consultation services as to the generics of establishing a research and development center. Mr. Joseph Robbins of Bellcore testified that Bellcore had agreed to provide consulting services but would not assume any operational role in connection with this

facility or in connection with Spain's tele-communications network. Thus, Pacific Bell asserts that, although services were certainly provided, no technology was transferred under the TELEFONICA proposal.

Fourth, the auditors claim that Pacific Bell transferred technology under the unsuccessful Thailand Digital Display Paging system ("TDDP") Proposal (Exhibit 619, p. 11-13; Exhibit 742, p. 8). Pacific Bell counters that it made no commitment to actually make its training facilities available. Further, Pacific Bell argues that DRA established no nexus between Pacific Bell's system and the system mentioned in the TDDP proposal and failed to establish that Pacific Bell had in fact committed its training facilities trainers and proprietary training courses. It also reiterates that this proposal was unsuccessful.

Fifth, as to the auditors' contention that PTI intended to transfer technology under the Thailand Outside Plant Proposal, and their special concern about the use of Pacific Bell's name, Pacific Bell counters that DRA auditors offer nothing more than conjecture and presented no evidence that technology was actually transferred. Further, Pacific Bell maintains that this proposal was also unsuccessful.

Sixth, DRA's auditors contend that Pacific Bell transferred technology to PTI under a proposal to provide services to the Koreans for the 1986 Asian Games and the 1988 World Summer Olympics, and also to Italy for the 1990 Soccer World Cup. The Asian Games and the 1990 Soccer Games proposals were unsuccessful. The 1988 Summer Olympics however, are another instance along with TELEFONICA, where services were actually provided. However, Pacific Bell claims these services were of a generic and administrative nature, and involved no transfer of technology (Pacific Bell Opening Brief, pp. 319-320). Also, Pacific Bell asserts that it was more than adequately compensated for the services provided in connection with the 1988 Summer Olympics,

maintaining that all services provided were transfer-priced; thus it believes the ratepayers were not harmed.

Next, the DRA auditors claim that Pacific Bell's Market Area Planning System ("MAPS") technology was transferred under the proposal for a wide-band network feasibility study (Exhibit 734, pp. 2-6). Pacific Bell asserts this is simply not true. First, it argues that the proposal was unsuccessful, and therefore no actual transfer has occurred. Secondly, Boro believes that DRA has misrepresented this issue because the MAP process in and of itself is not proprietary (i.e., the activities for conducting a market assessment). These matters are included in the Arthur D. Little Study which has been provided to the Commission as well as in Mr. Bandler's testimony (Exhibit 559), both of which are already public information and part of this record. In connection with the DRA claim that a Pacific Bell MAPs expert had been dispatched to Spain, Boro maintains that the particular employee was involved only to develop a questionnaire to determine the market potential for fibre applications in Madrid.

The auditors also claim that Pacific Bell's technologies were to be transferred to India under PTI's agreement to joint venture with its India-based Telecommunications Consultants, India, Ltd. (Exhibit 734, pp. 2-14 to 2-15). According to Pacific Bell, this proposal also was unsuccessful. Moreover Pacific Bell asserts it would have been compensated for any technology transferred.

Finally, the auditors claim that Pacific Bell Directory Techology has been transferred to PacTel Publishing (Exhibit 734, pp. 2-17 to 2-19) because PacTel Publishing had access to the utility's proprietary information, specifically its computer system. Pacific Bell attacks the DRA reliance on a letter from the vice president of PacTel Publishing to a third party which did not include an executive summary. Since the summary was not attached no analysis could be made of the underlying information in Pacific Bell's view. Pacific Bell also claims that the evidence presented

by DRA in support of its claim that a wealth of utility talent has gone into the development of PacTel Publishing's own computer system, in no way supports the contention that PacTel Publishing is asserting that it is "Publishing's own computer system" as DRA claims. The attachment in question refers to the yellow-pages computer system design as residing within the Pacific Telesis Group, and does not, in Pacific Bell's view, support the contention that PacTel Publishing is asserting it is "publishing's own computer system."

(f) The Bellcore Waiver

This is an issue that the auditors raised in connection with their claim that Pacific Telesis' senior management successfully blocked Bellcore from seeking a waiver that would have allowed it to offer its products and services to foreign business customers. DRA's auditors also contend that the sharing of the Bellcore Waiver establishes that business opportunities are being diverted from Pacific Bell to the affiliates and that the Bellcore Waiver was proprietary information that was impermissibly shared.

Boro's rebuttal testimony sets forth Pacific Bell's standard: proprietary information is that information which the owner does not wish to freely disclose pursuant to some legitimate business reason; therefore, Pacific Bell believes the true test of whether or not proprietary information is improperly shared is whether or not it was shared when the owner, here Pacific Bell, did not wish it to be shared. (Pacific Bell Opening Brief, pp. 324-325). Pacific Bell believes that, under this rule, proprietary information was not improperly shared. It relies principally on guidelines which clearly state that it may share proprietary information with its owner, PTG, under its S.I. 178. Thus it asserts there is nothing wrong with providing proprietary information to its owner at any time.

Further, in this instance, Boro believes it was appropriate to share the information in question with the PacTel

Companies because Pacific Bell wanted their input. Pacific Bell consciously decided to share the information and had already made its own independent decision as to what was best for it prior to sharing this information with its affiliates. Therefore, Pacific Bell argues the Bellcore Waiver information was not shared impermissibly, and the feedback from the affiliated representative was not dispositive in this instance since Pacific Bell had already made its decision prior to any input from either PTG or the PacTel Companies (Exhibit 740, pp. 10-11).

Pacific Bell also rejects the auditors' contention that it was not acting its own best interests on the Bellcore Waiver issue. Boro stated that the utility had three principal concerns: (1) Bellcore could potentially enter into lines of business which might be in direct competition with Pacific Bell; (2) Pacific Bell and its ratepayers could potentially be exposed to a costly and high risk international undertaking; and (3) the waiver could result in allegations of anti-competitive conduct. Boro also stated that if Bellcore were to win a contract which would otherwise have been awarded to Pacific Bell the ratepayers would share in only 1/7th, rather than 100%, of the proposal's proceeds. Therefore, if Pacific Bell had not opposed the waiver as it stood, Boro believes California ratepayers potentially could have been disadvantaged (Exhibit 740, pp. 11-12).

Finally, Pacific Bell asserts that the auditors have carefully obscured the fact that all Bellcore shareholders voted against the waiver as did Pacific Bell.

(g) Proprietary Information Does Not Readily Flow Between Pacific Bell and Its Affiliates

As proof of their claim that proprietary information is shared primarily through interlocking directorates, the auditors relied on various information including an alleged tip to PacTel InfoSystems about a $20 million contract, the circulation to the

PacTel CEOs of Pacific Bell's Strategic Technology Plan for 1985, the Agreement between PTI and CWA which granted PTI a license to market Project Victoria Products internationally, and the sharing of the Bellcore Waiver with PTI. Pacific Bell addresses each of these instances. First, as discussed previously, Pacific Bell regards proprietary information as that which has actual or potential value from not generally being known to the public or to other persons who can obtain economic value from its disclosure or use; it is information which the owner does not wish to freely disclose. Therefore, as long as in each of these instances the information was shared because Pacific Bell wished to share the information, it views the event is benign (assuming no ratepayer harm has otherwise been shown).

In connection with DRA's claim that PacTel InfoSystems was given advance notice that Pacific Bell intended to request bids on a $20 million project, the utility asserts that there was a verbal canvass of the entire marketplace as an informal part of its pre-RFP process. Companies canvassed included ComputerLand, The KYA corporation, MicroFinancial, Personal Computer Selection, and the West Coast Computer Center. The RFP was ultimately awarded to MicroFinancial Corp., Info Mac Incorporated, Sun Computers and Moore Cooperation Ltd. Thus, Pacific Bell maintains the sharing was part of a pre-RFP process, PacTel InfoSystems was one of but several vendors involved in this process, and the ultimate award did not go to PacTel InfoSystems in any event.

Pacific Bell admitted the accuracy of the auditors' claim that the 1985 Strategic Technology Plan was shared with PacTel CEOs, but indicated that the situation did not repeat itself in 1986 (Pacific Bell Opening Brief, p. 330).

According to Pacific Bell, the claim that Pacific Bell improperly shared proprietary information about Project Victoria with PTI through the use of CWA as a conduit (CWA is Carse, Woodworth and Associates), is specious. Under the terms of an

existing contract between Pacific Bell and CWA Communications Projects (CCP), CCP does have a license to talk to anyone concerning marketing Project Victoria, but is strictly forbidden to disclose the proprietary details of that project to third parties without the prior written consent of Pacific Bell. Pacific Bell states that it has no knowledge that such disclosure has occurred. According to Pacific Bell, the DRA is convinced that the utility has shared Victoria Technology with PTI if only because PTI has a license from CCP to market Victoria Products internationally. But Pacific Bell maintains that license calls for CWA to provide PTI the necessary technical information to market the Victoria Products CWA attempts to sell. It criticizes DRA for jumping to the conclusion that Pacific Bell and PTI are using CWA as a sham through which they funnel proprietary information about Victoria. Pacific Bell asserts that the agreement between PTI and CCP has not been shown to be other than a legitimate agreement struck between two parties. It acknowledges that CCP and CWA are indeed related, but asserts that the Pacific Bell agreement with CCP contains a non-exclusive license to make and market products based upon Victoria technology as part of the compensation for researching and developing Victoria. Pacific Bell denies any direct nexus with CWA. (Pacific Bell Opening Brief, p. 332.)

(h) The AT&T License Agreement

Pacific Bell believes that it has demonstrated that DRA's claim that "a large portion of AT&T's pre-divestiture intellectual property rights designated for Pacific Bell were transferred directly or indirectly to Pacific Telesis and to all of its subsidiaries" is incorrect. DRA has focused on the agreement Bellcore executed with its owners, the operating companies, which transferred Bellcore's rights to Bell Operating Companies (such as Pacific Bell). DRA claims that the rights in question are those to the intellectual properties associated with the centrally developed computerized operating systems funded by the ratepayers under the

AT&T license contract agreements. The DRA concludes that the agreement means that all the ratepayer financed Bellcore international properties have been granted to Pacific Bell's affiliates free of charge. The DRA also claims that revenue opportunities rightfully belonging to Bellcore and Pacific Bell will be diverted to the affiliates because PTG will license these properties to third parties.

Pacific submits the testimony of Robbins of Bellcore to the effect that:

> "The right to use intellectual property created prior to divestiture was conveyed by AT&T directly to the seven regional companies. It is important to note that this conveyance applies to all intellectual property owned by AT&T and used in connection with the provision of exchange and exchange access services, regardless of how it was funded. Included is intellectual property which had been funded via the License Contract, the Business Information Systems (BIS) Agreement, and Conduit Billing Arrangements as well as intellectual property created and/or paid for by the Western Electric Company" (Exhibit 778, p. 3).

Robbins explained that the seven regional companies were given the right to use the intellectual property they would need for the provision of exchange and exchange access services by the terms of the MFJ, the Plan of Reorganization, and divestiture agreements between AT&T and each of those companies. Bellcore also has the right to use this intellectual property since it is a named affiliate in the divestiture agreements. Therefore, he testified that the right to use the properties was transferred at divestiture directly from AT&T to regional companies and Bellcore. In view of this testimony, Pacific Bell maintains that the auditors are clearly wrong in their claim that Bellcore itself transferred intellectual properties (Pacific Bell Opening Brief, p. 335).

As to the DRA auditors' claim that intellectual properties have been transferred to Pacific Bell's affiliates

without charge so that the affiliates can relicense them, Robbins testified that Bellcore has the exclusive right to license intellectual property developed by Bellcore after divestiture, thus giving it exclusive ownership and control over that property. Therefore, no transfer or relicense can occur because Bellcore controls the licensing of the intellectual properties it develops. Under the agreement each owner who participates in a project creating an intellectual property may use that property without paying license fees to Bellcore, but it may not itself grant a license to use that intellectual property. If the owner wishes a third party to access the intellectual property, it is necessary for that owner to request that Bellcore grant a license to that third party. Therefore, Pacific Bell maintains the only agreement which governs the intellectual property created by Bellcore and its owners does not operate as the auditors allege. Under the agreement's terms, Pacific Bell, even though it is an owner of Bellcore, believes it is not empowered to license to any third party, including its affiliates, the right to use any intellectual property covered by that agreement.

Pacific Bell believes that PTG policies governing any transfer of intellectual property developed since divestiture from Pacific Bell to an affiliate provide full and complete protection against cross-subsidy. According to Pacific Bell if the intellectual property in question has already been provided to a non-affiliated third party, "obviously" the market has determined a fair price, and Pacific Bell promises it will charge that price. Where a prior sale has not taken place, Pacific Bell promises that it will price the property at the higher of incremental cost or market price, utilizing the assistance of an independent appraiser to establish market price (Exhibit 744, p. 14). Furthermore, should Pacific Bell provide such property to an affiliate it believes it must offer that property to all non-affiliates under the same terms and conditions. Thus, Pacific Bell asserts there

are viable safeguards in place to protect the ratepayer interest and DRA auditors' allegations concerning intellectual property should be rejected.

E. PacTel Companies' Position on the Issue of Affiliate Transactions

1. The Royalty Proposal is Arbitrary and Unsupported By the Evidence

PacTel Companies regard the DRA proposed royalty of 5%, to be arbitrary in several respects.

First, the 5% royalty is supposed to measure "intangible" benefits received by the affiliated companies, but the same 5% will be paid by an affiliate who realizes enormous gross revenues and net losses and a sister affiliate with small gross revenues and large net profits. The same 5% will be paid by a PacTel Company that has no identifiable relation with Pacific Bell and by a sister affiliated company that is closely related to the utility. The same 5% will be paid by a PacTel Company even if its gross revenues change radically from one year to the next, notwithstanding that its overall relationship with the utility has not changed at all over the two-year period. Thus, the PacTel Companies believe the royalty proposal would operate in ways that are totally disconnected with its underlying objective.

Second, the PacTel Companies believe that DRA has been unable to offer any rational basis for the choice of a 5% of gross revenues royalty, to be applicable in every circumstance, representing minimum unquantifiable and intangible benefits received by each PacTel Company from Pacific Bell. This formula is inherently arbitrary, in the PacTel Companies view, for despite the fact that a particular affiliate's relationship with Pacific Bell would remain unchanged on a year-by-year basis, because of the loss of a major contract or some other event, the Company's gross revenues might plummet from $25 million to $5 million and its gross receipts royalty would drop from $1.25 million to $250,000. PacTel

Companies assert that DRA has apparently rejected the subsidiary-by- subsidiary analysis that the Commission adopted in the SDO decision in favor of a "meat-ax approach". (PacTel Companies' Opening Brief, p. 9).

The PacTel Companies argue that the benefits they receive from Pacific Bell are quantifiable, they are being paid for, and if any benefits have been missed in the pricing process, the solution is simple: Identify the benefits, price them, and require the PacTel Companies to pay for them.

Third, the PacTel Companies dispute existence of unquantifiable or intangible benefits in the three areas where the auditors have concentrated their analysis: (1) Name, reputation, and heritage; (2) Transfer of technology; (3) the "Catch-all Category". These items are discussed below in order:

(a) Name, Reputation and Heritage

The PacTel Companies assert there are several flaws in the DRA auditors' argument that intangible benefits exist, associated with name, reputation, and heritage. First, the PacTel Companies assert that the utility's customers paid for telephone service, no more and no less and that they got what they paid for. That reputation does not belong to customers any more than as other utility properties such as central offices, poles, or headquarters buildings. Reputation is a shareholder asset.

The second point is that the successor of the old Pacific Telephone and Telegraph (PT&T) is not Pacific Bell, but Pacific Telesis. The business formerly conducted by PT&T is now being conducted by both Pacific Bell and the PacTel Companies (for example, the customer premise equipment previously provided by PT&T is provided now by PacTel). Thus, PacTel has just as much right and reason to refer to its heritage as a descendent of PT&T and the Bell System as does Pacific Bell.

Third, PacTel Companies maintain that references by them to the reputation of PT&T are cost-free to Pacific Bell's customers, and thus there is no ratepayer harm in this regard.

Fourth, there is no analogy between the relationship of franchisees and franchisors and the relation of diversified subsidiaries to their parent. The PacTel/Pacific Bell relationship is not a franchise and does not have the attributes of a franchise. (PacTel Companies' Opening Brief, pp. 12-14). In addition, the PacTel Companies term DRA's analysis of franchise fees an "after thought survey" since it was begun over two months after the 5% royalty proposal was published. They argue the analogy has no relevance to the fact of this case. Moreover they believe there is a more precise analogy to the relation between Pacific Bell and PacTel--a parent company and its diversified subsidiaries. For example, American Express has subsidiaries engaged in businesses as diverse as travel services and stock brokerage. The subsidiaries advertise their common parentage and common heritage, but they pay no royalties to their parent, much less to each other. If goods or services are transferred between the subsidiaries, they are paid for just as PacTel pays for what it gets from Pacific Bell.

Fifth, the use of logos adds nothing to the staff's argument in PacTel Companies' view. There is no analogy between the cited logo-licensing examples and the emphasis by PacTel on its heritage in AT&T and the Bell System.

If the royalty recommendation is somehow connected to the argument that the PacTel Companies have overstated their accomplishments and given themselves credit for achievements of Pacific Bell and PTG, none of this supports imposition of a royalty in PacTel Companies' view. The situation can be accommodated by the payment of a fair price. In sum, it makes no economic sense for wholly owned subsidiaries to exchange payments for the right to be part of an affiliated group, and there is no economic basis on

which the amount of any such payments could sensibly be established.

(b) Technology Transfer

The PacTel Companies agree that Pacific Bell should be compensated for any of its proprietary technology that is transferred to the PacTel Companies, but assert that this has nothing to do with the question of whether a royalty should be imposed. A royalty is not the appropriate remedy, since it has no connection to the value of what was transferred.

The PacTel Companies also aver that none of Pacific Bell's proprietary technology was actually transferred, asserting that DRA auditor Kenney was apparently misled by repeated references appearing (for the most part) in PTI proposals and documents that seem to indicate that PacTel might sell Bell Technology to prospective customers. The PacTel Companies cite the example of the Korean Olympics Games where PacTel contracted and paid for experienced people, but not for Pacific Bell proprietary technology. It paid a price for those people based on their fully loaded cost to Pacific Bell i.e., salary, plus benefits, plus all direct and indirect overhead, plus Pacific Bell's allowed return--the total of which generally runs about three times actual salary--plus an additional 10% profit (PacTel Companies Opening Brief, p. 19). In short, PacTel Companies argue that PTI and Korea were buying consulting services, not Pacific Bell's proprietary technology.

In situations where PacTel actually proposed the transfer of Pacific Bell proprietary technology to a third party (for example, the PTI proposal to sell operating procedures for Digital Data Service to British Telecom), if any of these proposals had reached the final contract stage, PTI would have concluded an agreement with Pacific Bell's Assets Sales Group relative to the sale of this technology. However, none of these proposals reached that stage.

The PacTel Companies assert that auditor Kenney's insistence that Pacific Bell's Project Victoria Technology had found its way into PacTel's hands was not supported by the evidence. Pacific Bell's witness Boro testified that none of the Victoria technology had been released by Pacific Bell, and PacTel's Long testified that none of the Victoria Technology had been received by PacTel. The PacTel Companies also believe that the auditors' argument about the use of the consultant CWA as a medium by which the Victoria Technology found its way to PTI also led down a blind alley: no evidence of any actual transfer of technology was discovered.

(c) "Catch-All Category"

This is the category of allegations relating to a miscellany of intangible benefits. The first relates to the "who owns what name/who got what technology at divestiture" dispute. PacTel Companies believe the record demonstrates that at divestiture AT&T intellectual property was transferred to Pacific Telesis, not Pacific Bell, and that Telesis was free to make that intellectual property available to its subsidiaries without charge.

Another claim in the so-called "catch-all category" was the assertion that PacTel, with the connivance of Pacific Telesis, seized valuable corporate opportunities from Pacific Bell. The leading example was the Bellcore foreign waiver case. When Bellcore proposed to its owners that it enter the foreign consultant business in competition with PTI and its counterparts and the other RHCs, Pacific Bell chose to ask PTI what it thought. PTI was unenthusiastic. Pacific Bell and the other six owners later voted unanimously that Bellcore should focus its attention on the home front.

The PacTel Companies believe that the DRA auditors have not really appreciated the flip-side of their recommendation i.e, that Bellcore had been considering undertaking some risks in

the international environment, and that Pacific Bell's customers are currently shielded from these risks.

Another catch-all category is the assortment of claims relative to the use of Pacific Bell employees who were not paid for, late payment of bills by PacTel, sloppy recordkeeping and accounting systems etc. PacTel Companies acknowledge that some of these claims have validity, while others do not. However, they assert none would support imposition of a royalty, although in the aggregate they demonstrate the need for improved procedures and recordkeeping. The PacTel Companies submit that those procedures are now in place or "in the works."

2. Other Criticisms of the Royalty Proposal

The PacTel Companies assert that the 5% royalty would continue until the PacTel Companies were driven out of business. (PacTel Companies' Opening Brief, pp. 34-35). A much more modest royalty suggested by the staff in the Rochester case (1% of the first $100 million of net sales to non-affiliates and 1/2 of 1% of the next $100 million) has not been adopted by the New York Public Service Commission (Exhibit 742, p. 46). And PacTel Companies believe this Commission's decision in the SDO proceeding provides no support for the result being urged here. The PacTel Companies acknowledge that it is difficult to quarrel with the decision to inquire into whether a given affiliate should be subjected to a royalty. But in this case the DRA auditors have flatly rejected a case-by-case examination of the need for a royalty based on the circumstances of each PacTel affiliate. Further, PacTel Companies believe imposition of the royalty would violate the law. Specifically the PacTel Companies cite Public Utilities Code § 1705 given their argument that there are no facts in the record that support a royalty and given the amount of evidence pointing the other way. Further, such an order imposing a 5% royalty would violate the substantive due process clause of the U.S. Constitution, since,on independent judgment, the California Supreme

Court could only conclude that there is no evidentiary support in this record for the imposition of a royalty. Finally they assert that the Commission's decision will be set aside as arbitrary and capricious unless that decision demonstrates a rational connection between facts found and choices made (PacTel Companies' Opening Brief, p. 40).

3. The PacTel Companies' Opposition to DRA's Proposed Referral Fee

Under the current method, new Pacific Bell customers are referred to PacTel InfoSystems as the potential vendor of the customer premise equipment (CPE) that Bell is forbidden to provide; the latter has paid its full cost for each referral--whether or not the referral ultimately produces a sale for PacTel--plus a profit of 10% (Exhibit 674, p. 41). PacTel Connection and PacTel Spectrum have also received some customer inquiries that result from prior customer contacts with Pacific Bell. These inquiries, though potentially valuable are unsystematic, unsolicited, and uncontrollable by PacTel recipients (Exhibit 674, p. 27; Exhibit 742, p. 24).

The PacTel Companies oppose the DRA auditors' recommendation that they be required to pay a fee equal to 13% of the revenue derived from each Pacific Bell referral to them in addition to Pacific Bell's recovery of its costs plus a profit on each referral from Pacific Bell to PacTel InfoSystems.

The PacTel Companies assert that there is no basis for DRA's concern about potential competition from PacTel; in addition the referrals to InfoSystems are relatively unproductive and diminishing rapidly. They assert the involvement of Connection and similar CPE vendors is essential to Pacific Bell Centrex sales because Centrex is useless without telephones which Bell can't sell.

The PacTel Companies argue that the 13% referral fee, if applied to the rapidly shriveling referrals from Pacific Bell to

InfoSystems would effectively end those referrals. In the first six months of 1986, referrals from Pacific Bell to InfoSystems had fallen to less than 4,300 (about 25% of the referrals that had been received in the previous year). This number continues to decline according to PacTel Companies.

Referrals from Pacific Bell to InfoSystems are only marginally profitable and much less productive than sales contracts generated from other sources. DRA's notion that referrals from Pacific Bell are "presold and therefore very valuable" are contradicted by several facts, including the success ratio for referrals (17.7% versus close to 50% for non-Pacific Bell contracts); 1986 Pacific Bell referrals to InfoSystems accounted for approximately 45% of total contracts, but the revenues generated by those referrals accounted for less than 25% of the revenues of InfoSystems' Telemarketing Center; costs of the InfoSystems TMC are separated between sales generated by Pacific Bell referrals and those from other sources; even when no advertising expense is allocated to sales Pacific Bell referrals, the net before tax revenue on those sales is less than 6% of gross revenue. This is much less than the margin on sales derived from non-Bell sources (almost 7%), and it is less than half of the fee--13% of gross revenues--that DRA proposes to charge. The PacTel Companies object to DRA auditor Woods' calculation of the return on Bell referral sales, which assigns all of the InfoSystems advertising expense to sales from other sources and all other expenses on the basis of revenues. Woods' calculation showed that sales from referrals from Pacific Bell were much more profitable than sales from other sources. By making just one correction to Woods' calculation--allocating expenses incurred in handling contracts on the basis of both contracts and revenues--the net profit before taxes of the Telemarketing Center drops to less than 6%. The allocation of any of the Telemarketing Center's

Advertising Expense to Pacific Bell's referral sales would drop the profit even lower.

The PacTel Companies assert that Pacific Bell needs PacTel more than PacTel needs Pacific Bell in this instance, because the utility must have the participation of vendors like PacTel Connection in order to sell its Centrex and Premier Services.

4. The PacTel Companies' Opposition to the 25% Employee Transfer Fee

The PacTel Companies oppose the DRA auditors' recommended fee to be imposed on each employee transferred to PacTel from Pacific Bell; the suggested fee is 25% of the employee's starting salary with PacTel. the PacTel Companies assert that the auditors have not demonstrated or even tried to show that the movement of employees from Pacific Bell to the PacTel Companies has been harmful to either Pacific Bell or its customers. Further, the PacTel Companies assert that the numbers are trivial. For example, as of June 1, 1986, only 147 of PacTel's almost 1,200 management employees were emigres from Pacific Bell. (Exhibit 675, p. 31; Exhibit 742, p. 36). Finally, the PacTel Companies believe that the 10% fee currently in effect on the net transfer of employees between the two entities is remedy enough.

Further, the PacTel Companies assert that the contract employee program, wherein PacTel Companies have used Pacific Bell employees as so-called contract employees, employing them as consultants who assist in preparing a proposal to a PacTel project or provide expertise in serving one of PacTel's customers, is beneficial to all concerned. In addition, the PacTel Companies expect to pay, and do pay, consulting fees for these employees. The standard rate is the employee's salary plus benefits, plus all direct and indirect loadings and overheads, plus return on Pacific Bell's investment, plus 10% (Exhibit 674, p. 29; Exhibit 675, p. 30; Exhibit 742, pp. 12-13).

The PacTel Companies also dispute the DRA auditors' suggestion that PacTel Companies are free to pick and choose among Pacific Bell employees with the utility bearing the brunt of any resulting shortages. The PacTel Companies assert that the determination of which employees are available as consultants and for how long is Pacific Bell's own (Exhibit 742, pp. 34-35).

F. Pacific Telesis Group's Position on Affiliated Transactions Issues

1. Opposition to the Royalty Proposal

(a) Policy Concerns

PTG opposes the royalty as completely lacking in precedent. It notes that New York Public Service Commission is considering more limited version of the royalty, as previously noted, but has not yet ruled on this issue. In addition, the royalty proposed by DRA goes beyond the SDO decision wherein the Commission stated that each subsidiary's payments would depend on the benefits received or costs imposed on the utility. Further, PTG argues that DRA's suggested royalty, premised on intangibles rather than concrete services rendered, is akin to the old license contract fee which the Commission found objectionable as having "no rationale relationship to the reasonable costs of services actually rendered to Applicant by [AT&T] and its affiliates." (Re Pacific Telephone & Telegraph Co. 48 Cal. PUC 1, 11 (1948).

Assuming arguendo the existence of risks and intangible benefits, PTG asserts that intangibles can be priced as part of observable transactions between Pacific Bell and its affiliates (Exhibit 656, p.4-27). Further, any "risks" can be handled through conventional ratemaking via, ratemaking disallowances.

PTG points to several harms associated with the royalty proposal. PTG's witness Stigler asserted that imposition of a royalty would result in inefficiencies. Further he found the proposal to be violative of economic principles for efficient transfer pricing. (Exhibit 656, @ 30-32). Assuming the Commission

decided to impose some charge for intangibles, Stigler felt that a methodology should be chosen that would not cause economic distortions. (i.e., unlike the proposed royalty, it should not increase over time as the affiliate grows and its revenues increase, where the alleged benefits occur if at all at the beginning of an affiliate's existence and decrease over time). Second, Stigler believes the proposal does not differentiate between affiliates on the basis of amounts of benefits received. In contrast, the existing 10% surcharge on transfer priced transactions does not cause such distortions in PTG's view.

Additionally, Stigler believes the royalty will injure existing shareholders and will produce uncertainty about how regulators will allocate other benefits between ratepayers and shareholders. Moreover the royalty would discourage diversification, thus tending to reduce the likelihood of contributions by the unregulated affiliates to the utility, thereby harming ratepayers. Stigler also believes ratepayers will suffer from the effects of reduced competition should PTG be discouraged from diversifying and encouraged to leave existing ventures.

(b) Fairness Concerns

PTG believes that the auditors are attempting to double charge the PacTel Companies by recommending both a royalty and substantial payments (a 13% referral fee, a 25% fee on permanent personnel transfers, continuance of the transfer pricing 10% surcharge, and other assorted disallowances in connection with assets transfers).

PTG asserts that the royalty is not matched to benefits. The affiliates can't control the fee that will be imposed, and they can't modify their conduct to reduce the royalty. The royalty will be automatically imposed even on revenues from companies which have been acquired by PTG. Some of these acquired companies may be out-of-state companies, thus raising other fairness concerns about subsidization of California telephone rates

with revenues from these out-of-state corporations. Finally, PTG asserts it is unfair to impose a royalty on the affiliates when their competitors in real estate development, computer and telephone equipment sales, and other areas are not subject to similar "tax".

PTG attacks the auditors' position that the ratepayer has "paid for" Pacific Bell's good will as contradictory to past decisions of the Commission disallowing "image advertising." Citing past Commission disallowances for poor service, PTG argues that since the shareholder is penalized for poor service, in fairness, the shareholder must be allowed to reap the rewards of good service, rather than being penalized again by imposition of a royalty.

PTG argues that "intangibles" are not included in Pacific Bell's rate base, and Pacific Bell investors have not derived any return on these "intangible" assets for this reason. Thus, assuming arguendo the validity of DRA's franchise analogy, PTG asserts that DRA has not carried the analogy to its logical conclusion. It wants to have Pacific Bell collect the same royalty that MacDonald collects, but forgets that the utility's shareholders have never been permitted to earn anything for the "good will" for which they paid.

(c) Legal Issues

PTG asserts that the proposed royalty is contrary to Federal and California law. It asserts that the arbitrary, speculative, and inconsistent nature of the proposed royalty, and the lack of evidence to support it, mean that, if enacted, the royalty would violate the due process rights of PTG and its subsidiaries.

The second argument PTG advances is that the royalty would confiscate Telesis' property without just compensation, because revenue allegedly derived from the intangibles is imputed to Pacific Bell, but Pacific Bell has never earned its authorized

rate of return on these assets. PTG asserts that legal authorities hold that in setting a public utility's rates, the value of its intangible assets must be taken into account and the utility is entitled to earn a fair rate of return on all of its assets including intangibles. Pacific Bell's rates should have been set by a formula which included these assets in its rate base. If income from these assets is imputed to the regulated utility, its revenue requirement is correspondingly reduced. If the same assets have never been included in rate base there is a double confiscation--rates are reduced, yet no corresponding opportunity to earn on the assets has been given. (PTG Opening Brief, p. 21).

PTG also asserts that the proposed royalty violates its equal protection rights. First, DRA is not proposing to apply its royalty to other regulated utilities at this time, due to lack of staff resources. Second, the royalty, in order to comply with the equal protection clause must be rationally related to a legitimate government purpose, which PTG asserts is not the case.

PTG's final argument is that the Commission cannot force Pacific Bell to start a new business which is not part of its franchise obligations. Yet the auditors, in discussing the basis for the royalty assumed the Commission has the power to penalize it for not publishing a visitor's guide or for not seizing other "opportunities". None of these opportunities are part of Pacific Bell's franchise obligations, according to PTG. Finally, PTG asserts that the FCC's Computer II decision has pre-empted the Commission's power to impose a royalty on the CPE affiliate, PacTel InfoSystems. PTG asserts that this would be the case because the royalty would reduce Pacific Bell's revenue requirement, in violation of the following portion of the Computer II decision:

> "Earnings of the subsidiary from unregulated activities shall not be imputed to the parent's regulated activities or serve to alter the parent's revenue requirements." [Citations omitted] (PTG Opening Brief, p. 26).

(d) Proposal Not Supported by the Record

PTG makes several points. First, it asserts that the DRA auditors have approached their task as advocates for the ratepayer rather than in conformance with accounting standards of "independence" described by the American Institute of Certified Public Accountants (AICPA). It cites examples of auditor testimony which assertedly did not take a balanced view (PTG Opening Brief, pp. 29-30).

PTG asserts that Pacific Bell is fully compensated for all transactions with its affiliates, for several reasons. It believes the transfer pricing guidelines are stringent and enforced. PTG maintains it has responded to Commission requirements and staff's suggestions about transfer pricing guidelines, and that, Pacific Bell has already been compensated for all intangible benefits transferred to the affiliates via the transfer pricing mechanism. (These arguments are found in the PTG Opening Brief, pp. 31-36 and are not exhaustively detailed, since they duplicate arguments already presented by other opposing parties).

PTG counters the DRA allegation that Pacific Bell is harmed by interlocking directors and joint officers. PTG counters DRA allegations about the Bellcore international waiver, the decision to purchase 2150 Webster Street, and the decision whether to expand the directory business geographically or topically. These items have been extensively discussed previously. Further, PTG asserts that there is no indication that any PacTel Company ever acquired an asset that should have been acquired by Pacific Bell. Further, on the issue of the sharing of officers, PTG does acknowledge some inadvertent errors in complying with FCC rules on this topic (PTG Opening Brief, p. 40, footnote 10). However, PTG asserts that this Commission has not required separate officers and directors in two recent cases in which it considererd structural separation issues. (The first case involved the Commission's

decision requiring General Telephone to set up a separate CPE subsidiary, and the second was the SDO decision. (PTG Opening Brief, pp. 40-41)).

PTG asserts that the alleged information flow from Pacific Bell does not require a royalty. PTG believes that the Telesis guidelines prevent the release of proprietary information, and although there was a lapse in the case of the strategic technology plan for 1985, steps have been taken to ensure that this will not recur. Second, PTG repeats the arguments already advanced by Pacific Bell and PacTel Companies that no transfer of technology actually occurred. PTG also asserts that no royalty can be imposed based on the transfer of intellectual properties, since ratepayers do not own such assets. PTG also makes other arguments with regard to prior disallowances of development costs associated with intellectual properties transferred under the Plan of Reorganization (PTG Opening Brief, p. 44), and the transfer of intellectual property pertaining to cellular technology or CPE, (which was transferred at divestiture to PTG rather than Pacific Bell).

PTG also asserts that alleged lost opportunities do not support a royalty. PTG asserts that no such profitable lost opportunities have been identified on this record, and that Pacific Bell's ratepayers have been protected in any event by having risky ventures financed by shareholders. Further, the Commission cannot penalize Pacific Bell for electing not to go into business that is not part of its franchise obligations. Finally, if the Commission chooses to impose a penalty for lost opportunities the proper way to do that, in PTG's view, is to impute the lost revenues.

PTG asserts that employee transfers and loans do not support imposition of a penalty, since the PacTel Companies are already paying for such loans and have agreed to pay a fee on net transfers. Additionally, it argues, as have other opposing

parties, that Pacific Bell has benefitted in other ways by the transfers and loans (PTG Opening Brief, pp. 47-49).

Similarly, PTG asserts that referrals from Pacific Bell do not support imposition of a royalty since the utility is already compensated for the cost of referrals, and is studying whether a "market price" for referrals can be charged. PTG believes this is a double recovery recommendation. In addition, it notes that the FCC Computer II rules require recovery of the costs of referrals but explicitly forbid any revenue imputation to Pacific Bell. Since the proposed 5% royalty is nothing more than a revenue imputation, in PTG's view, it is impermissible.

PTG also counters the DRA claim that risks to Pacific Bell and its ratepayers support imposition of a royalty. It believes that the 9 risks outlined by the DRA in its rebuttal testimony (Exhibit 734, Chapter 1) are purely speculative. These risks include the diversion of managerial and technical Bell resources to the PacTel Companies, the safety net issue previously discussed, the exposure to additional liabilities (such as judgments), exposure to increased cost of capital, and the diversion of regulatory resources. On the latter point, PTG asserts that the problems of affiliated companies are not new to DRA and the Commission. Even if these risks are significant, PTG believes that a royalty is not the appropriate response, since traditional ratemaking penalties are more apropos.

PTG, like the other opposing parties, believes that the franchise analogy used by DRA to support its royalty proposal is not valid, principally because the DRA failed to show that the franchisors it studied provided services similar to those provided by Pacific Bell to its affiliates.

PTG also argues that use of the Bell name, reputation, and heritage does not support a royalty, that the DRA has not proved that the name and good will of Pacific Bell has any independent marketable value. It cites Stigler's testimony

(reviewing an academic treatise) arguing that in the real world, corporate affiliates or divisions are not charged for name or reputation (Exhibit 656, @ 12-14). PTG believes that any benefit from the use of Bell goodwill is covered by transfer pricing.

2. Opposition to the Referral Fee

PTG considers the DRA showing in support of its 13% fee to be seriously flawed. In addition, Pacific Bell has indicated that its costs for referrals are covered and that it is studying the possibility of a market based price, although the study had not been completed by the time the record was submitted. (TR 19956-57).

PTG, like the PacTel Companies, criticizes the methodology used by DRA auditor Woods in arriving at the 13% recommendation, including her allocation of a 41% expense figure (sales from referrals were 41% of total sales). PTG believes a higher figure, recognizing increased telemarketing center costs, should have been used. This changes the value of referrals dramatically (Exhibit 742 @ 26-27). Second, Woods assumed that all advertising costs should be allocated to non-referral sales. Since advertising costs are a large part of all expenses, this allocation results in a high profit for sales from referrals and a much lower profit for all other sales. The difference between the two figures was 13%, a difference caused entirely by the allocation of advertising costs. (TR 15946-48; Exhibit 628, 628-A). Advertising costs should not be allocated in this way according to PTG, for there is no evidence that the referral calls resulted automatically in sales. PTG also asserts the advertising budget "might have" included sales brochures mailed to customers including referred callers. Finally, Woods deducted computer-related income and cost of goods sold, but did not analyze whether part of advertising expense should also have been deducted as computer-related. Yet PTG argues that her interview notes revealed that she had examined InfoSystems' advertising, and much of it was computer-related. For all of these reasons, PTG believes the 13% fee is not merited.

3. <u>Opposition to the 25% Employee Transfer Fee</u>

PTG assets that the already agreed upon fee of 10% on net permanent employee transfers is reasonable. At the end of each year, total transfers to the PacTel Companies from Bell and total transfers from the PacTel Companies to Bell will be compared. The party receiving the higher number of transfers will pay 10% of the difference in salaries.

PTG notes that its attempt to critique DRA's rebuttal testimony on the methodology for calculating the 10% net employee transfer fee, via Witness Laico's surrebuttal testimony, was not allowed into the record by the ALJ. This matter was discussed extensively on the record (at TR 19878-19907; 19996-19998). PTG's request for a reversal of the ALJ's ruling granting the DRA motion to strike this portion of Laico's testimony is denied, since a review of the hearing transcript demonstrates that this calculation methodology was not a "new issue" upon which surrebuttal testimony would be allowed. The "new issues" were originally designed in Pacific Bell's motion to strike (Attachment II), and PTG therefore was apprised of the new issues which might be ultimately addressed on surrebuttal, subject to subsequent ruling by the ALJ.

Returning to the substantive question, PTG asserts that the underlying DRA analysis is incorrect in assuming that recruiting costs and training costs accumulate over an employee's working life and thus should be recovered in full upon departure. Instead, PTG believes these costs should be amortized over a reasonable period "surely shorter than 10 years," in PTG's view.

PTG also opposes the DRA headhunter analogy, for its asserted failure to analyze the costs incurred by such firms, not applicable to Pacific Bell. These costs include: marketing and advertising, costs incurred for clients who aren't placed, bad debt expense, refunds that must be made if the employee leaves the firm within a short period of time, etc. (Exhibit 677 @ 15-17).

4. The San Diego Conditions

PTG views the San Diego Conditions recommended by DRA as inappropriate and unnecessary. PTG asserts that the Commission lacks the power to impose these conditions on an existing holding company, created as part of the settlement of a major antitrust case. (PTG does not assert any legal authority for this proposition, however).

Specifically, PTG discusses Conditions 4, 5, 8, 12, 15, 16, 17, and 18. Relative to Condition 4, PTG believes the Commission lacks the authority to impose a particular accounting method (the USOA) on the unregulated affiliates. It believes Condition 5 would improperly permit the DRA to select which witnesses would appear for Telesis.

Condition 6 would require prior notice of transfer of assets. There are several reasons why, in PTG's view, the Commission lacks power to do this. First, the assets do not belong to the ratepayer; second, prior notice would substantially interfere with Pacific Bell's management prerogatives and would hamper it in carrying out these transactions; finally, the Commission can review these transactions after they have occurred under PU Code § 851.

PTG believes Condition 12 would impose an artificial net equity ratio on Bell, and Condition 16 would impose a 15% limit on Telesis' investments in the diversified businesses. Again, PTG believes the Commission lacks these powers. PTG makes a similar argument about Conditions 15 and 17. (Condition 18 relates to the royalty proposed, which PTG opposes).

G. SDG&E's Position

As noted previously SDG&E participated as an interested party in this case, given its interest in the affiliate payment proposal first introduced in the SDO decision. SDG&E urges the Commission to reject the auditors' royalty proposal on the grounds that it is arbitrary, speculative, and illegal.

SDG&E argues that the Commission has no direct authority over unregulated businesses and cannot require a private business to pay a royalty to an affiliated utilities' ratepayers. In addition, it believes that such a royalty would be an improper extension of ratemaking authority. Absent a showing that ratepayers will be charged an unreasonable cost for service as a result of a transaction between a regulated company and its affiliate, the Commisson does not the authority to order a regulated company to charge its affiliate for benefits allegedly conferred on the affiliate as a result of its relationship with the regulated company. SDG&E views this as beyond the reach of the Commission's regulatory authority. SDG&E also argues that intangible benefits are not ratepayer assets. In this argument it echos arguments made by the other opposing parties.

SDG&E also argues that the royalty proposal is not cost-based. It cites prior Commission decisions which have required that payments between affiliates be based upon costs incurred. For example, in City of Los Angeles v Public Utilities Commission, 7 Cal 3rd 331, (1972), the Supreme Court of California described the Commission's practice:

> "Historically, the Commission has rejected the amount computed on the percentage-of-revenue basis when determining Pacific's reasonable expenses for the purpose of setting rates. In lieu of the percentage-of-revenue computation, the Commission has used for rate-setting purposes the actual costs to American for services rendered to Pacific." (id., @ 348).

SDG&E also asserts that the record lacks sufficient evidence to support a finding that a royalty should be imposed.

Finally, SDG&E challenges the legality of the royalty. It asserts that the royalty proposal would violate the Commerce Clause of the U. S. Constitution, given (i) the lack of a state interest, (ii) the resulting burden on interstate commerce, and

(iii) the existence of alternatives which are less burdensome but which would also accomplish the state's objectives.

SDG&E also maintains that the royalty proposal violates the equal protection clause of the 14th Amendment as not rationally related to a legitimate government purpose. And finally, the utility contends that the royalty would be an unconstitutional deprivation of property without just compensation (SDG&E Opening Brief, p. 13-14).

H. SoCal Gas' Position

SoCal Gas intervened in this proceeding in opposition to the royalty proposal. SoCal Gas' arguments echo other opposing arguments in great measure, and are addressed extensively only where it raises new points. SoCal Gas makes several policy-related arguments in opposition to the royalty payment, which it terms a matter of first impression in this state. SoCal Gas believes that the royalty is beyond the jurisdiction of the Commission to impose given the fact that neither Pacific Telesis nor its affiliates are public utilities. (SoCal Gas Initial Brief, p. 10-13). It further asserts that the statutory basis (Public Utilities (PU) Code § 854) which gave rise to the SDG&E holding company decision, is not present in this case, since the Commission is not considering approval of a holding company acquiring the stock of a regulated utility. There is already an existing holding company. The only authority being sought is the authority to increase rates pursuant to PU Code § 454.

SoCal Gas also believes that the attempt to impose a royalty would violate three different federal constitutional guarantees: (1) The fifth and the 14th Amendments of the U. S. Constitution (prohibiting the taking of property without just compensation); (2) the Commerce Clause of the U. S. Constitution; and (3) the equal protection clause of the 14th Amendment. (SoCal Gas Initial Brief, pp. 17-24).

Even if the affiliate payment were lawful, SoCal Gas believes it is wholly unjustified and improper policy. This is because, in its view, the intangibles upon which the proposal is based are of little or no benefit to the affiliates, and in any event the ratepayers have no equitable claim on such benefits. SoCal Gas also disputes the applicability of the franchise relationship analogy proffered by DRA (SoCal Gas' Initial Brief, p. 27-30). It asserts that appropriate transfer pricing policies eliminate the need for any royalty (SoCal Gas Initial Brief, p. 30-33).

SoCal Gas believes that imposition of a royalty at this time based on this evidentiary record would be a grossly disproportionate remedy for an alleged breach of the transfer pricing guidelines by Pacific Bell. SoCal Gas believes DRA's auditors have failed to demonstrate anything other than minor lapses by Pacific Bell and its affiliates in following these policies. These lapses are understandable in SoCal Gas' view given the huge upheavals created by Divestiture.

Even assuming that the justification had been made for some kind of royalty, SoCal Gas disputes the merits of a 5% royalty.

SoCal Gas believes that the Commission is not committed to a royalty as a matter of policy based on the SDO decision. It further argues that the assessment of a royalty in this case will undoubtedly start a disastrous trend. As evidence of this trend, it cites the DRA testimony in the Southern California Edison test-year 1988 general rate case wherein DRA makes the same 5% recommendation (SoCal Gas' Initial Brief, p. 42).

SoCal Gas points out that its parent Pacific Lighting Corporation (Pacific Lighting) has been diversifying into non-utility ventures for many years, primarily by acquiring existing successful businesses completely unrelated to its utility operations. SoCal Gas asserts that if the Commission adopts the

DRA recommendation in this case, which fuels the trend already started, the financial consequences would be enormous. If such a royalty were assessed on the gross operating revenues of its nonutility affiliates for the year 1986, SoCal Gas states the royalty would have exceeded $125 million, which approaches SoCal Gas' entire net earnings of $164 million (SoCal Gas Initial Brief, p. 44).

SoCal Gas also opposes other DRA recommendations. The first is the DRA recommendation that the Commission adopt SDO Condition No. 16. SoCal Gas submits that the Commission should not limit the degree of holding company diversification, arguing that this is not necessary to protect utility ratepayers. It believes that DRA's testimony in support of this proposal is extremely conclusory and this, in addition to the fact that the Commission lacks the authority to order a nonutility corporation not to acquire another nonutility, makes the recommendation defective.

SoCal Gas also opposes the adoption of the condition that there be prior notice to the Commission before sale of nonutility assets (Condition 17). It does not understand the DRA rationale for this condition, and terms the condition itself "highly impractical". The notice-before-sale condition is also unlawful in its view, since the Commission has no jurisdiction over sales by nonutility corporations of a nonutility subsidiary. Finally, the benefit of advance notice is unclear to SoCal Gas, since it believes the Commission has no legal authority to approve or disapprove the sale of a nonutility business.

DRA auditors also recommend a condition requiring annual submission to the Commission of a detailed 2-year capital budget and financing plan for the holding company and each of its subsidiaries. SoCal Gas agrees that utility capital budget and financing plans are entirely proper for submission, but questions submission of the same information with regard to nonutility affiliates or the holding company. It maintains the disclosure of

affiliate plans could be harmful to shareholders, raising concerns about release of confidential information. Again, SoCal Gas believes the Commission is without jurisdiction over the holding company and the nonutility affiliates, and cannot impose this budget and financing condition.

I. Discussion

1. Introduction

We have followed a consistent approach in reviewing Phase 2 issues, including the issues posed by the audit of affiliated transactions, which bear on the reasonableness of Pacific Bell's operations. As noted in the introductory portion of this opinion, we have placed the ultimate burden of proof of reasonableness on the utility. The auditors are the moving parties as to the merits of their recommendations, including the 5% royalty, the 25% employee transfer fee, the 13% referral fee, and the imposition of additional guidelines and conditions. Where the auditors have presented documentary evidence pointing to the existence of problems with affiliated transactions, we have looked to Pacific Bell to provide counter information, sufficient to support reasonableness findings in Pacific Bell's favor. This is due to the fact that Pacific Bell is the repository of the information we must review in making such findings in the area of affiliated transactions. We have also imposed a burden on the auditors of producing evidence supporting the necessity for adopting their recommendations, and the reasonableness of those recommendations. However, we have not shifted the ultimate burden of proof of reasonableness, and where we believe the utility's response does not measure up to this standard, our findings reflect that fact.

2. The Royalty Proposal

As can be readily judged from the foregoing positions of the parties, the questions of a royalty and affiliate transactions have

been among the most contentious in this proceeding. Before addressing the merits of this particular case, we think it is appropriate to state certain fundamental principles that we will use regarding affiliate issues. (PU Code Section 851 et. seq.)

First, we are determined to make the ratepayer indifferent to the formation of a holding company type of organization as well as to the operations of any affiliates or subsidiaries. Our objective is to provide the mechanisms that will ensure this ratepayer indifference. It therefore follows that a utility and its ratepayers must be compensated for any flow of actual resources or benefits to an affiliate. We believe this is our unquestioned continuing responsibility.

Second, we will judge each utility individually as to its relationship to a holding company or to affiliates. While the general principle of ratepayer indifference is common across utilities, the specific facts may merit some differences in treatment from utility to utility. Given the complexity of utility-affiliate transactions, we are committed to assuring that ratepayer indifference will in fact occur.

As to the facts of this case and based on the foregoing principles, we simply are not persuaded that DRA's recommendation for a 5 percent across-the-board royalty should be adopted. We do not agree that a substantial flow of intangible benefits exists which jeopardizes ratepayer interests; instead, we prefer to rely upon tangible measures to value and compensate for tangible flows of resources or other benefits from utility to affiliate which have an identifiable effect on ratepayers. We should not at this time define all other "benefits" as "intangibles," however, because in the future we may find cases that show particular "benefits" flowing to affiliates that are not as yet clearly identified.

We find the notion of intangible benefits troubling. DRA and others argue that Pacific Bell's affiliates are receiving

difficult-to-specify benefits of uncertain size from their association with Pacific Bell and the Bell System legacy. Royalty advocates simultaneously argue that (1) transfer price mechanisms do not and cannot evaluate these flows, but that (2) a 5 percent royalty is appropriate compensation for their value.

Our basic transfer pricing theory has been to charge the affiliate the higher of cost or market value for transferred services. In this way, we protect ratepayers by assuring that the utility treats an affiliate just as it would any other unaffiliated firm; that is, charge what the market will bear, but decline the transacton if the market will not pay at least the cost of providing the transferred service. The 10 percent surcharge applied to these transactions provides an additonal margin to help ensure that ratepayers are not harmed.

Intangible benefits as defined by this decision are provided at no direct cost to the utility. However, there are other benefits (like technical information) that may be costless to provide yet valuable to receive. We question why a market pricing standard can be used for other costless services, but not for "intangibles." This skepticism has been reinforced by the evidence of so-called "intangible" benefits presented in this case, which we do not find convincing. We are persuaded that intangible "benefits" of any appreciable magnitude can be identified and priced by an appropriate market pricing standard. Therefore, we do not agree that specialized and imprecise additional measures are called for; instead, we find that the set of measures imposed by this decision will combine with previously-ordered measures and continuing Commission oversight to ensure that ratepayers are protected.

Later in this decision we adopt new transfer pricing standards on a trial basis for employee transfers and for referrals, two other transactions that share this characteristic

of little or no direct cost yet a substantial benefit (employee transfers and referrals). The evidence presented on these points made the alleged benefits quite tangible in our minds; and, DRA provided convincing rationales as to how a market would price these services. The measures we adopt today will amply achieve our objective of protecting ratepayers from any adverse impacts due to Pacific Bell's relationships with its holding company and affiliates.

In our prior SDG&E holding company decision we expressed our concerns on the subject as follows:

> "Whatever pressures may be operating upon management to [pursue] diversificaton, we cannot permit the process of diversification to become a vehicle for eroding the cost-effective investment base of the utility. We must assume that top management as well as the Commission has a strong interest in fully weighing the impact of affiliate ventures on the utility and specifically on its capacity to serve the public ..."

No one should question the need to preserve the strength and vitality of the regulated utility.

3. <u>The Employee Transfer Fee</u>

We will adopt the DRA recommended 25% employee transfer fee because we believe, despite the counter arguments, that this fee, imposed on a "one-way" basis, more precisely captures the costs avoided by the PacTel Companies when they hire Pacific Bell employees, than does the present 10% fee. We are not convinced that the focus should be on the costs of effecting such transfers to Pacific Bell (i.e., recovery of sunken costs associated with providing services to affiliates) or that such a focus would be a better measure. Rather, the focus should be on approximating the market value of the benefits associated with such transfers, and received by the affiliates, including an analysis of the costs

avoided by them as a result of obtaining employees from the regulated utility. The fee is set at 25% of the transferred employee's starting salary in order to compensate Pacific Bell for these costs (Exhibit 619, p. 13-6). The test year impact of our action is $1,270,000.

We choose to increase this fee based on the evidence presented by DRA and others showing a current need for an increased fee. We will implement this additional fee on an interim basis. After 18 months of experience with it, we will review the results of a further CACD/DRA study to review how well the increased fee is working to protect ratepayers without hindering appropriate transfers between Pacific Bell, Pacific Telesis, and the various affiliates and subsidiaries.

4. Referral Fee

We will adopt the 13% referral fee proposed by auditor Woods, despite opposing parties' criticism of the method Woods employed in developing her recommendation. We believe it was reasonable for Woods to exclude advertising costs from referral sales, in developing her proposal, absent any affirmative showing that advertising costs are actually incurred in connection with such referrals.

The auditors have effectively rebutted the PTG argument that Woods admitted that advertising "encouraged customers to accept a referral."(PTG Opening Brief, p.63). Auditor Woods implicitly stated that the Pacific Bell referred customer has already made a decision to buy from the Telesis affiliate, and that thus advertising could reinforce the customer decision. The PTG argument implies that advertising was an important impetus to the customer decision, but this was not the tenor of the testimony. Further, the DRA auditors have reviewed Exhibit 654, in response to PTG's contention that InfoSystems' advertising is largely computer-related, and that Woods' recommendation did not account for the interrelationship of these two items; the auditors indicate that

there are no documents in that exhibit which would indicate that this is the case. (DRA Reply Brief, p.83).

For clarification, the affiliates should continue to pay Pacific Bell for the cost of referrals on a transfer priced basis, but in addition, we believe affiliates receiving referrals from Pacific Bell should be required to pay 13% of the sales revenues resulting from any Pacific Bell referrals in order to approximate the market value of these referrals.

The impact of the adoption of the Woods proposal on the 1986 test year is $1,527,000.

As with the increased employee transfer fee, we will adopt the 13 percent referral fee on an interim basis pending a further review by CACD and DRA of its effectiveness and appropriateness.

5. Land Sales Adjustments

We believe the auditors have demonstrated that the appraisal of the 420 Cowper Street property should have been premised on the figure of $2,250,000, to include the $250,000 correction to account for the improper downward negotiation of the property's value prior to its sale to the affiliated company PacTel Properties. We do not find Pacific Bell's explanation (increase in refurbishment costs as affecting the appraisal costing methodology; Exh. 740, p. 19),a convincing counter to McCrary's "downward negotiation" argument (Exh. 740, p. 19), and that is the reason why we are adopting auditor McCrary's dollar recommendation for Phase 2. The test year impact of crediting this gain to Account 174, as the auditors recommend, is $403,000. Further, the crediting of this gain to Account 174 is consistent with the approach we took in the Phase 1 decision in dealing with similar issues (D.86-01-026, mimeo. pp. 82-83; ordering paragraph 7). Because of the limited record on this issue in this phase, we will not reconsider the ratemaking treatment decided in the Phase 1 decision.

Auditor McCrary also has a related recommendation in connection with disposition of property located at 2150 Webster Street in Oakland. The recommendation is that a second study be conducted to determine the value of Pacific Bell's right to purchase 2150 Webster Street, which should include the following:

1. The relationship of the party exercising the option to purchase to Pacific Bell;
2. The selling price of the property if Pacific Bell vacated it;
3. The lease rate of the property if Pacific Bell vacated it.

We reviewed the 2150 Webster Street gain issue in Phase 1, and specified the ratemaking treatment in D.86-01-026, as previously noted. We will not revisit that issue now. Nonetheless, as a general matter , we believe McCrary has raised a legitimate point for the future, and we will adopt the auditors' suggested guidelines for valuing such rights to purchase, on a prospective basis.

6. The SDO Conditions

As noted previously, the auditors are recommending that certain of the conditions imposed in the SDO decision be imposed as a result of our Phase 2 review of affiliated transactions. The opposing parties have responded to this recommendation as previously outlined in the discussion of their positions.

We should first note that there are some significant distinctions to be drawn between Pacific Bell and San Diego Gas and Electric (SDG&E). We find SDO conditions 2 (with a clarification), 8, 11 (in part), and 14 suitable for adoption for Pacific Bell, Pacific Telesis and their affiliates and subsidiaries at this time.

We first note that no parties advocated adoption of SDO conditions 1, 6, 7, 19, or 20. Also, condition 18 is adequately disposed of by our preceeding discussion regarding DRA's royalty proposal.

Condition 2 clarifies that the Commission should have access not only to relevant books and records of holding companies and affiliates, but also to those held by joint ventures. We do not intend to inappropriately expand the Commission's authority by establishing this condtion; we intend only to clarify that our existing authority under PU Code § 314(b) would apply to a joint venture if a circumstance requiring the use of this existing authority should arise. We shall therefore modify condition 2 to clarify its limited purpose.

Condition 8 provides for notification to the Commission regarding substantial asset transfers from Pacific Bell to affiliates, regardless of Pacific Bell's opinion on whether such assets are used and useful for ratemaking purposes. This notification does not presuppose any Commission action or response, but merely provides an opportunity for Commission action if circumstances should warrant it, before the act becomes a fait accompli. If necessary, Pacific Bell can ask that such information be held as proprietary under the usual guidelines and procedures.

DRA has recommended that condition 11 be adopted as a notification requirement only. We agree that information regarding affiliate use of Pacific Bell transmission facilities may prove useful for monitoring purposes. If such usage becomes frequent, these reports may be aggregated into quarterly presentations.

Condition 14 prohibits Pacific Bell from guaranteeing any financing sought by Pacific Telesis or any of its affiliates and subsidiaries. This basic financial protection is essential to the financial independence of Pacific Bell.

We are not persuaded to adopt any of the remaining conditions in this case. Condition 3 speaks to a general need for appropriate transfer pricing, a subject we are addressing in some detail otherwise. Condition 4 was criticized by DRA as poorly worded, and our investigaton into the Uniform System of Accounts will produce more specific results. Condition 5 would require

relevant affiliate personnel to appear before the Commission without subpoena. As we are aware of no recent case in which we have ever issued a subpoena to compel such a person to appear, this requirement appears unnecessary; however, abuse of this understanding would encourage this Commission to swiftly rethink this conclusion. Condition 9 is duplicative of one of the regulatory conditions proposed by the DRA auditors that we impose further on in this decision (Ordering Paragraph 34(e)). Conditions 12, 13, 15, and 16 would speak to Pacific Bell's need to be adequately capitalized to provide utility service. We have addressed these issues repeatedly in this and other proceedings; indeed, in our order addressing Pacific Bell's 1987 attrition we imputed for ratemaking purposes the capital structure we had previously found reasonable rather than the current capital structure, which had changed from that we had specified. There are a number of scenarios that could result in inadequate capitalization; while some of these could involve diversion of capital by Pacific Telesis, we would find any of them to be unacceptable. Given our demonstrated willingness and ability to determine and enforce an appropriate capital structure by direct reference to Pacific Bell and its service requirements, we decline to specify further conditions upon Pacific Telesis in this regard.

Condition 10 establishes a procedure that has some theoretical attractiveness but may be impractical in universal application. The best test that Pacific Bell is not favoring affiliates would be a general offer to transfer services and information to any competitor wishing it. However, the process of defining and tariffing (whether formally at the Commisson, or informally in the sense of careful definition of all terms and prices) all such transfers would probably be unduly burdensome. We note that it would be in Pacific Bell's interest to follow such a procedure where a significant demand may exist for a given service, or where its management believes that improper transfers may be

taking place. Also, the market price established through such a process could be strong evidence regarding the appropriate transfer price for regulatory purposes; with such information, Pacific Bell might reduce its burden of establishing reasonableness before the Commission. Thus, while we commend this process to Pacific Bell as potentially in its self-interest, we choose not to impose it as a blanket requirement.

Condition 17 requires advance, confidential notice of any sale or divestiture of Pacific Telesis subsidiaries. As Pacific Bell ought not to have any direct interest in such subsidiaries, we are unsure why such notification is necessary. Should Pacific Bell develop any interest in such a subsidiary, we would consider it a matter of immediate concern regardless of whether that subsidiary was targeted for divestiture.

7. Further Audit

We accede to the recommendation that the audit continue to address joint ventures, strategic alliances and R&D issues. We are concerned that the auditors adhere to the proposed time line they have provided and complete the audit within three months from the date of issuance of our Phase 2 decision.

Since the work of the auditors is not complete, we believe it is appropriate to keep the $4 million revenue requirement adjustment in place pending completion of this further audit. The adjustment, first imposed after Phase 1 in D.86-01-026, due to noncooperation with the auditors' efforts, should remain in place until the auditors' efforts have concluded. Our experience in Phase 2, while not on a par with the episodes recited in D.86-01-026, leads us to conclude that the contentious environment surrounding the auditors' work hampered the development of the record.

The opposing parties made the presentation of the audit results difficult, objecting at every turn to the introduction of documents that were originally (in most instances) obtained from

them, on grounds of "lateness" or prejudice associated with "surprise." We recognize that when there is a great deal at stake and tremendous policy issues are before us, with the types of consequences that these recommendations presented , it is very likely that the hearing process will become more contentious. However, the right of our staff to audit is beyond question. It is authorized by statute , and it is a crucial part of our regulatory oversight in a time of increasing utility diversification and emerging competitive markets. That is why we look askance at litigation tactics that make the auditing task more difficult than it already is.

Therefore, the obstacles that were erected to hamper the presentation of the audit results in Phase 1 and Phase 2, indicate the need to retain the $4 million adjustment in place as an incentive to future cooperation. This is especially so, because the opposing parties object to a continuation of the audit, and can be expected to raise further roadblocks in the absence of an adequate incentive.

Finally, in order to assure the continued effectiveness of our conditions in protecting ratepayers from any adverse consequences and to assure appropriate Commission access to transaction data, we wish to study the effectiveness of the conditions we impose today on the level of activity between Pacific Bell and its affiliates. We will direct the Commission's CACD and DRA to coordinate in preparing a report summarizing the effectiveness of the conditions we impose today in achieving our objective of ratepayer indifference, and documenting the level of transactions and other activities taking place between Pacific Bell and its affiliates. In preparing this report, CACD and DRA should make the best use of the information that Pacific Bell will be providing to DRA pursuant to this and previous Commission decisions. This report should characterize the degree and extent of interaction between Pacific Bell and each of its affiliates,

identifying, at a minimum, (1) numbers and types of transactions, (2) instances where specific Commission guidelines regarding affiliate relationships are being applied, (3) the complete range of Commission guidelines and restrictions that apply to Pacific Bell's relationships with its affiliates, and, (4) the extent to which each of these guidelines and restrictions is affecting actual utility -- affiliate activities. We will want to be informed as to the effects of the increased employee transfer fee and of the 13 percent referral fee. CACD and DRA should also consult with the relevant parties to this case regarding any potential refinements to these guidelines and restrictions, as we may want to revisit them at that time. However, we intend this report as a review of how well our conditions are working rather than an opportunity to revisit the broad range of affiliates issues litigated in this case.

This report should be prepared within 24 months of this decision, and should reference the 18 months of experience to follow this decision.

In this follow-up audit, we will expect and insist upon full cooperation by Pacific Bell and its affiliates.

This proceeding will remain open then for the presentation of the DRA auditors' recommendations in the areas of joint ventures, strategic alliances and R&D projects.

In the meantime, the $4 million revenue requirement adjustment will remain in place pending completion of the further audit of joint ventures, strategic alliances and R&D projects in Phase 3.

As an additional measure of protection, we will also adopt in today's order several of the protective guidelines recommended by auditor Lew to assist future oversight of affiliated transactions.

In conclusion, we find that this set of disallowances, additional ratepayer protections, and the exercise of this

Commission's authority for ongoing review will appropriately shield ratepayers from any adverse consequences as a result of Pacific Bell's relationships with it holding company and affiliates.

Ultimately, it will be management's decision that determines the future path of diversification and affiliate transactions. A high road result will most probably come from management decisions that structurally separate regulated and unregulated operations, protect the regulated company's name, identity, capital, personnel, technology, "know how" and business income and pay a fair price for all interests of value received by the affliate from the regulated company. The "other road" is full of uncertainties and other dangers caused by confusion of the regulated company's property and interests with the business of the affiliate. We prefer the high road because it is the smooth and sure road into the future.

XIV. Modernization

We designated as a Phase 2 issue the review of Pacific Bell's plant use and modernization programs (D.86-01-026, mimeo. p. 5). However, as noted earlier, we have deferred consideration of Pacific Bell's A.D. Little Report and DRA's SRI Report, as well as DRA's recommended $43 million modernization-related disallowance, to Phase 3 of this proceeding, where we will consider modernization issues more comprehensively.

Nonetheless, an extensive evidentiary record was developed during Phase 2, aimed at issuing a policy-related decision to assist in framing the issues for the Phase 3 modernization review. Pacific Bell, DRA, and CPIL presented evidence on these Phase 2 modernization issues, and filed opening and reply briefs, containing extensive arguments and analysis.

We will address these arguments in a separate modernization decision to be issued in the next few weeks. For now, it is necessary to publish the ALJ draft decision on Phase 2 RO issues without delay, and consequently, without addressing the modernization issue. We note that the modernization issue itself has no impact whatsoever on the Phase 2 revenue requirement calculation, given our deferral in D.86-08-079 of the DRA's proposed $43 million disallowance (Exh. 754, Table A). In contrast, publication of the ALJ's draft decision at this time is necessary so that we can reach a decision on Phase 2 revenue requirements issues by year-end 1987, while still complying with PU Code Section 311.

XV. The Retroactive Ratemaking Question

Ordering Paragraph 1(a) of D.86-03-049, which modified D.86-01-026, in response to various applications for rehearing, provides as follows:

> "Pacific Bell's...intrastate rates and charges shall be collected subject to refund back to March 5, 1986 in view of the further reductions in revenue requirements which could result depending on the outcome of issues to be addressed in the next phase of these proceedings."

Pacific Bell believes, assuming that any further reductions are warranted as a result of Phase 2, that application of any part of those adjustments to rates charged, or expenses incurred, back to March 5, 1986, would violate the ban on retroactive ratemaking. Pacific Bell presented extensive argument on this question in its opening and reply briefs, although the issue was not really addressed by any other party.

Public Utilities Code § 728 provides as follows:

> "Whenever the Commission, after a hearing, finds that the rates or classifications, demanded, observed, charged, or collected by any public utility for or in connection with any service, product, or commodity, or the rules, practices or contracts affecting such rate classifications are insufficient, unlawful, unjust, unreasonable, discriminatory, or preferential, the Commission shall determine and fix, by order, the just, reasonable, or sufficient rate, classifications, rules, practices, or contracts to be thereafter observed and in force. . . ."

Pacific Bell focuses on the statutory language "to be thereafter observed and in force", and says the language is "plain and unambiguous." (Pacific Telephone and Telegraph Co. v Public Utilities Comm'n (1965) 62 Cal 2d 634, 650 (PT&T). Pacific Bell argues that the rule against retroactive ratemaking mandates that ratemaking adjustments such as those in question in Phase 2 can only be applied to revenues collected or expenses incurred after the decision specifying the rate adjustments, which in this case is this decision, rather than D.86-03-049.

Pacific Bell maintains that the Commission could avoid the spectre of retroactive ratemaking in several ways. First, if the Phase 2 revenue requirement remains the same as that ordered in D.86-03-049 at the conclusion of Phase 1, there would be no retroactive ratemaking concern since the Phase 2 decision could not affect prior rates or revenues. Similarly, if the Phase 2 decision determines that an adjustment is warranted and applies that adjustment only from the date of the Phase 2 decision forward, no retroactive ratemaking problem would be presented in Pacific Bell's view, since again no past revenues would be altered. Pacific Bell maintains however, that a retroactive ratemaking situation would develop if the Commission attempted to apply newly decided ratemaking adjustments, increases, or decreases, to rates for services provided before the Phase 2 decision is rendered.

Pacific Bell argues that Ordering Paragraph 1(a) of D.86-03-049 directly conflicts with the holding of the PT&T case. First, Pacific Bell contends that the ordering paragraph impermissibly contemplates the rolling back of general rates already approved by an order which has become final (Pacific Bell contends that D.86-01-026 became final when the Commission issued D.86-03-049 on March 5, 1986). Second, it contends that Ordering Paragraph 1(a) unlawfully contemplates the ordering of refunds of amounts collected by Pacific Bell pursuant to D.86-01-026 prior to the effective date of the Phase 2 revenue requirements decision.

Pacific also expresses a third, policy-related concern, maintaining that the Commission's decision to make all of its revenues subject to refund needlessly increases investor perception of risk, since investors are uncertain whether "any dollar earned by Pacific Bell will be retained." (Pacific Bell Opening Brief, p. 433.)

Thus, Pacific Bell's position is that the Commission should not apply any effects of the Phase 2 decision back to March 5, 1986. Rather, Pacific Bell contends that the revenue requirement adjustment, if one is ordered, can lawfully be applied only on a going-forward basis from the effective date of the instant decision.

Pacific Bell maintains that no case or statute can be cited which grants the Commission the authority to declare all of the utility's rates subject to refund pending the completion of hearings to be held at a later time. Nor, according to Pacific Bell, does any authority hold that the rule against retroactive ratemaking is avoided if the Commission simply labels all of the utility's revenues "subject to refund" before starting hearings on the issues. At bottom, Pacific Bell maintains that the Commission cannot avoid the rule against retroactive ratemaking by simply labelling Pacific Bell's rates subject to refund.

Pacific Bell's arguments ignore the fact that our "subject to refund" designation was narrowly tailored, not open-ended. The Commission does not engage in impermissible retroactive ratemaking where it first makes a utility's rates subject to refund for a specified purpose and thereafter determines the amount to be adjusted by going back to the date of the "subject to refund" order. In the "interim" order in our Phase 1 decision, we specifically designated Pacific Bell's rates subject to refund so that we could conduct a review in Phase 2 of certain precisely delineated issues, in furtherance of our charge to ensure the reasonableness of Pacific Bell's rates.

Pacific Bell's arguments also ignore the fact that the rates previously approved in our interim order were rates subject to refund to account for the issues specifically reserved for Phase 2. These issues were:

"1. Whether to remove the $45.4 [sic] million adjustment to reduce gross revenue requirement imposed by D.83-12-025, continued by D.84-06-111 and addressed further by D.85-09-085.

"2. PacBell's plant use and modernization programs (aside from the adjustments ordered by D.83-12-025).

"3. The overall labor improvement productivity factor to be applied in PacBell's attrition filings for 1987 and 1988 (Resolution ALJ 156, adopted on October 17, 1985, directed PacBell to have two attrition years after test year 1986).

"4. Review of the effects of the industry-wide shift of revenue from carrier access services on PacBell's settled test-year revenue from carrier access services.

"5. Whether to recognize the synchronization of interest on accumulated deferred investment tax credits for purposes of computing income tax expense for ratemaking.

"6. The results of staff's completed audit of PacBell's transactions with affiliates in the Telesis Group and staff's analysis of PacBell's San Ramon Valley Complex.

"7. PacBell's endeavor to comply with our past decisions and otherwise encourage female and minority business enterprise.

"8. The full ambit of rate design issues." (D.86-01-026, mimeo. pp. 5-6).

All of the revenue requirements adjustments that flow from today's decision relate to these defined issues, and are

premised on findings of reasonableness associated with these defined issues following our Phase 2 review.

We believe that the California Supreme Court has previously approved our use of "subject to refund" rate orders in at least one case which is particularly analogous to the situation we face here. In Southern California Gas Co. v. Public Utilities Commission (1979) 23 Cal 3d 470, 487, the Commission issued orders in April and June 1975, subjecting SoCal Gas' rates to refund "should the Commission determine that [SoCal Gas] has a reduced revenue requirement resulting from its investment tax credit election under the Tax Reduction Act of 1975." (23 Cal 3rd at 487.) In March of 1976, the Commission determined the amount by which SoCal Gas' revenue requirement should be reduced on account of its investment tax credit election, and ordered refunds. The Supreme Court upheld this Commission's order.

In sum, our "subject to refund" proviso here, like that in SoCal Gas, was a carefully tailored reservation, keyed to precise issues to be developed in Phase 2 of this proceeding. Accordingly, application of the reductions specified in this order as of the March 5, 1986 effective date of our "subject to refund" order does not constitute impermissible retroactive ratemaking.

We will order the revenue requirement reductions flowing from our Phase 2 review to be applied as of March 5, 1986.

XVI. Billing Changes

Our adopted revenue reduction for all the issues previously addressed in this decision is derived as follows:

Table 1

Summary of Revenue Requirement Changes
($000)

Description	Implementation Dates 3/5/86	6/1/86	1/1/87	1/1/88	Total
True up of InterLATA Pool	28,469				28,469
True up of IntraLATA Pool	(72,540)				(72,540)
Account 645		14,268			14,268
Direct Assignment of WATS		(8,247)	(692)	(15,479)	(24,418)
DRA's IntraLATA SPF to SLU				(12,078)	(12,078)
Interest Synchronization	(28,653)				(28,653)
ZUM Expansion	(15,088)				(15,088)
Telesis Audit	(3,203)				(3,203)
Advice Letter Adjustments	(5,900)				(5,900)
Plant Underutilization	31,639				31,639
F/MBE	1,069				1,069
Total	(64,207)	6,021	(692)	(27,557)	(86,435)
Factor	2.82	2.58	2.0	1.0	
Total Change in Revenue Requirement	(181,064)	15,534	(1,384)	(27,557)	(194,471)
Today's Adopted Intrastate Revenue Requirement Reduction =					(194,471)

On December 18, 1987 Pacific Bell filed Advice Letter (AL) 15325 to reduce access service rates on an industry basis by $101.1 million to reflect the 1988 transition in allocation of non-traffic-sensitive cost from use of Subscriber Plant Factor (SPF) to Subscriber Line Usage (SLU). The industrywide reduction of $101.1 million results in an incremental adjustment in the billing surcharge on other than access services of 1.181%. The access service surcredit is adjusted by an increment of negative 0.427% to reflect the change in access service billing base. We will consolidate Pacific Bell's AL 15325 with this interim decision so that only one bliing surcharge/surcredit change will become effective January 1, 1988. This will reduce customer confusion.

We will adjust rates on a prospective basis to implement today's adopted intrastate revenue requirement reducton and the shift in revenue requirement in Pacific Bell's AL 15325 with a billing surcharge/surcredit effective January 1, 1988 which will remain in effect until January 1, 1989. We expect to revise or eliminate these surcharges when we implement a final rate design in our forthcoming Phase II Rate Design decision which we expect to issue before January 1, 1989.

The present billing surcharge/surcredit on other than access services is 1.287% and on access services is negative 5.363%. The reduction of $194.471 million results in a billing surcharge/surcredit adjustment for access services and other than access services by an increment of negative 3.29%. The SPF to SLU shift results in a billing surcharge adjustment on other than access services by an increment of 1.81% and an adjustment in the billing surcredit on access services by an increment of negative 0.427%. Combining these two incremental changes, the net incremental change in the present billing surcharge/surcredit is negative 1.48% for other than access services and negative 3.717% for access services, which yields a surcharge/surcredit on other

than access services of negative 0.193%, and on access services of negative 9.080%.

In D.85-06-113, dated June 12, 1985, we ordered that Ordering Paragraph 3 of D.85-03-056 be modified to read in full as follows:

> "3. Any reduction in AT&T-C's expense stemming from reductions in local exchange utilities' access charges shall be concurrently passed on to AT&T-C's customers through a corresponding incremental reduction in the billing surcharge. The tariff filings by AT&T-C to comply with this order shall be filed so that they are effective within 14 days after local exchange utilities have made the advice letter filings required to reduce their local access charges."

In accordance with D.87-07-017, we have recently received an application for rate flexiblity from AT&T-C. We are also aware of several pending rate matters that will affect AT&T-C's access charge expenses. For now, we will order AT&T-C to accumulate the access charge reduction ordered here in a memorandum account, with interest, commencing on the effective date of the tariff revision. We will issue a further order describing how the entire amount of this savings is to be consolidated with other changes in access charge expenses for full pass-through to AT&T-C's customers.

Findings of Fact

1. Pacific Bell filed A.85-01-034, a general rate increase application, requesting authority to increase rates by approximately $1.4 billion based on a 1986 test year. Thereafter this Commission issued I.85-03-078, and consolidated this investigation with A.85-01-034 for the following purposes:

a. Placing Pacific Bell fully on notice that its rates could be reduced, as well as increased.

b. Enabling us to consider fully the ramifications of potential rate changes on the other respondents who join in a number of Pacific Bell tariffs, including those covering intraLATA toll and carrier access charges.

c. Facilitating the ordering of appropriate changes to Pacific Bell's rates, charges, or practices beyond those proposed by Pacific Bell itself.

2. Issuance of I.85-03-078 did not shift the ultimate burden of proof of reasonableness from Pacific Bell to DRA or any other interested party.

3. In assessing the burden of proof and where it ultimately rests in a ratesetting proceeding such as the instant matter, we distinguish between a disallowance or adjustment based on a finding of unreasonableness, and a penalty based on violation of statute, rule, general order, or tariff. In the former situation, where other parties challenge the utility's showing, such parties have the burden of producing evidence in support of such challenge and in support of adoption of their recommended ratemaking disallowance or adjustment, but the ultimate burden of proof of reasonableness is never shifted from the utility to the challenging parties.

4. In a ratesetting proceeding, where other parties allege that the utility has violated a statute, rule, general order, or tariff, the ultimate burden of proof regarding existence of the

violation and the appropriate penalty to be imposed rests with the party alleging the violation and seeking the penalty.

5. For purposes of analyzing the burden of proof in a ratesetting proceeding, it is necessary to distinguish between a ratesetting disallowance, based on a finding of unreasonableness, and a penalty imposed for a violation of law.

6. On June 26, 1985, the IRS issued proposed amendments to the Income Tax Regulations (26 CFR Part 1) under Section 46 (f) of the IRC indicating that interest synchronization is acceptable under the IRC.

7. It was the intent of Congress in adopting ITC provisions governing utilities, to enable the benefits of ITC to be equitably shared between investors and ratepayers.

8. An ITC is a prescribed percentage of investment in qualifying business property which may be used to reduce Federal income tax liability of a business on a dollar-for-dollar basis.

9. The Revenue Act of 1971 provided that a public utility could elect any of three options with respect to ratemaking treatment if ITC; Pacific Bell is an "Option 2" utility which means that it loses ITC eligibility for Federal income tax purposes with respect to any property, if the credit to which it would otherwise be entitled is flowed through to income faster than ratably over the useful life of the property.

10. The IRS Proposed Regulations provide that, although synchronization of interest reduces cost of service, this reduction is not attributable to the credit, consistent with financial market realities which would operate in the absence of the credit.

11. Subsequent to submission of this record, the IRS issued its final rules and regulations concerning the treatment of interest synchronization, by adopting the amendments proposed on June 26, 1985. The final rules and regulations were published in the Federal Register on May 22, 1986 (51 FR 18775).

12. The issue before us, given adoption of the proposed regulations, is whether interest should be imputed on the portion of Pacific Bell's plant financed by ITC, when determining the utility's Federal income tax allowance for ratemaking purposes, in furtherance of a sharing of ITC benefit between investors and ratepayers.

13. TURN, DRA, and the Cities of Los Angeles and San Francisco recommended adoption of the interest synchronization adjustment even before issuance of the final IRS rules and regulations on May 22, 1986, on the rationale that this would accomplish a greater ratepayer sharing of ITC benefits, with little or no realistic risk of loss of ITC eligibility.

14. Pacific Bell opposed adoption of the interest synchronization adjustment, even after issuance of the final IRS rules and regulation on May 22, 1986, on the rationale that the adjustment constitutes unsound ratemaking. Even after issuance of the final regulations, Pacific Bell maintains that the IRS is not effectuating congressional intent relative to "sharing," and that the regulations are subject to legal challenge on that basis.

15. If this Commission opts to adopt interest synchronization Pacific Bell believes the revenue requirement impacts should be adjusted to account for (a) the 50% reduction in authorized rate of return applied to a portion of rate base (the so-called underutilization penalty, originally instituted in D.83-12-025), and (b) the effects of the Remand Case Closing Agreement, whereby, in settlement of IRS claims, Pacific Bell paid $103.5 million because of the prior improper flow through of ITC to ratepayers. $40.2 million of the $103.5 million, for which Pacific Bell opted not to seek rate recovery, remains to be amortized.

16. The ALJ allowed Pacific Bell to present evidence on the proposed adjustments noted in the previous finding, over DRA and TURN objections that such testimony was tendered too late. The ALJ

contemporaneously offered other parties an opportunity to address such testimony at a later time, but no party chose to do so.

17. TURN has moved to overrule the ALJ's ruling and strike Pacific Bell's late-added materials on the underutilization disallowance impacts and the Remand case effects.

18. There is no evidence that TURN was prejudiced by the ALJ's ruling allowing Pacific Bell to expand its showing, since the ALJ provided an opportunity for additional time to address the new issues.

19. Given adoption of the final rules and regulations on interest synchronization on May 22, 1986, over one year ago, it appears that Pacific Bell's concerns that the regulation will be overturned on legal grounds, with the consequent loss of ITC eligibility, are overly pessimistic.

20. Adoption of interest synchronization, consistent with the IRS rules and regulations on point, will effectuate a better sharing of ITC benefits between investors and ratepayers.

21. It is not appropriate to adjust the impacts of our adoption of interest synchronization to account for the underutilization penalty, since there is no evidence that interest expense has actually been disallowed, given the fact that the penalty is scaled to match plant accounts, but is not expressly related to any particular accounting treatment. Such adjustment would also reduce the penalty, thereby sending an opposite signal to the one intended.

22. It is not appropriate to adjust the impacts of our adoption of interest synchronization to account for the Remand Case Closing Agreement, despite the equitable argument raised by Pacific Bell, stemming from its voluntary decision not to seek rate recovery for amounts paid to the IRS due to prior improper flow through of ITC. The equities on the other side, stemming from the fact that ratepayers have not had the benefit over a period of

years of the increased sharing provided by interest synchronization, counterbalance the utility's equitable argument.

23. In this proceeding, DRA presented evidence proving that Pacific bell had violated PU Code § 532, General Order 153, and Tariff Rules 6 and 12 in connection with its marketing activities; based on this evidence the Commission issued D.86-05-072 ordering Pacific Bell to cease and desist from such violations.

24. At the Commission's direction, the E&C Division convened workshops involving the active parties, designed to develop the details of a CNP.

25. In D.86-08-026 the Commission adopted the CNP emanating from the workshops, with certain modifications, including provision for below-the-line treatment of CNP expenses, and a direction to Pacific Bell to accelerate its plans to provide detailed, or itemized bills to residential customers.

26. As of the time the Phase 2 record was submitted, Pacific Bell had refunded, pursuant to CNP, a total of $27.5 million to affected customers, at a cost of $11.3 million. Total shareholder costs were therefore approximately $39 million.

27. Various tracking studies ordered to monitor the CNP results indicate that the plan was not totally successful in reaching all affected customers (DRA calculates that the CNP reached only one-half of affected customers), and Pacific Bell has offered to work with the other workshops parties to develop and undertake a second notification campaign.

28. Although the success of CNP was one issue in further Phase 2 deliberations, the parties also recommended penalties be assessed against Pacific Bell for the violations leading to the issuance of D.86-05-072.

29. DRA recommended that Pacific Bell conduct a second refund notification campaign; that Tariff Rule 12 be revised to protect against future marketing abuses; and that the Commission impose a $49.5 million penalty on Pacific Bell (based on trebling a penalty

of $16.5 calculated as a reduction in net revenue of $8 million to reflect marketing salaries and benefits). DRA also recommended its $16.5 million penalty, without a trebling adjustment, if the Commission finds in mitigation that Pacific Bell's remedial efforts have been substantial and meaningful.

30. TURN recommends that DRA's $49.5 million penalty be increased to $100 million based on Pacific Bell's 611 referral and branded directory actions subsequent to issuance of the cease and desist order. TURN also recommends continuation of the CNP/workshop mechanism, and creation of a Consumer Advocate Trust Fund with a portion of the penalty monies it believes should be assessed against Pacific Bell.

31. Public Advocates recommends that an additional notification campaign and comprehensive multilingual lifeline outreach program (with a 75% goal) be required; if these two campaigns are undertaken, Public Advocates recommends that any penalty be modest, in the $7.5-$15 million range, and designed specifically to "educate the ratepayer."

32. Pacific Bell has agreed to broaden its notification and refund process, and given the fact that it has already spent approximately $39 million implementing CNP, it does not believe any additional penalty is warranted.

33. The CNP and its mandated below-the-line ratemaking treatment were restitutionary, or "make whole," remedies designed to restore victimized ratepayers to their position before the marketing abuses occurred. The question whether to impose a penalty, over and above the restitutionary remedies already ordered, is a separate issue, although it naturally involves some assessment of the effectiveness of the ongoing restitutionary approach.

34. Since the CNP has been less than totally effective to date, it is reasonable to require Pacific Bell (a) to continue the refund program and commence a second notification campaign, and

(b) to proceed with its lifeline outreach efforts, in accordance with the discussion in this decision and subsequent ordering paragraphs.

35. A limited purpose penalty, designed to deter future similar conduct and ensure that similar marketing abuses do not recur, and to avoid unjust enrichment, given the impracticability of reaching every affected ratepayer, is reasonable based on this record.

36. A general, nontargeted penalty, such as that suggested by DRA, may benefit those not harmed, or already recompensed, while ineffectively reaching those who have been harmed.

37. TURN has failed to prove that Pacific Bell's 611 referral and branded directory activities were activities in contempt of the Commission's cease and desist order; rather, such activities were apparent corporate lapses, which were promptly corrected by Pacific Bell at the time they became known on the public record.

38. A limited purpose penalty, totalling $16.5 million, is appropriately imposed on Pacific Bell, based on DRA's marketing salaries/benefits methodology and designed specifically to fund a ratepayer education program aimed primarily at ensuring that marketing abuses do not occur again; although no specific details have been provided on the record as to how such a penalty should be structured, this Commission may fashion its own remedy designed to achieve the targeted goal, as more specifically set forth in this decision.

39. It is appropriate, given the circumstances underlying our decision to impose a limited purpose penalty, that the $16.5 million penalty be funded entirely by Pacific Bell's shareholders.

40. The CMOC, established in today's order, in accordance with the proposed charter, Appendix C, has the overall mandate specified in the cease and desist order to address the specific issues detailed previously in this opinion.

41. DRA's recommended modification of Tariff Rule 12 is necessary, in order to fully detail the methods and procedures to be applied in processing orders for new service.

42. Public Advocates has requested a finding of eligibility on behalf of LULAC and CAA, setting forth in its filing information required by Rule 76.54(a)(2), (3), and (4) (statement of issues, estimate of compensation, budget) relative to its participation in the marketing abuse question.

43. Public Advocates, representing LULAC and other clients, has previously been found eligible for compensation for its participation in the F/MBE issue in this proceeding.

44. Public Advocates, on behalf of several clients including CAA, was found to meet the "significant financial hardship" test (Rule 76.54(a)(1) for calendar year 1986 in D.86-11-079.

45. Pacific Bell's bilingual program has two components: the Language Assistance Plan and the Hispanic Market Plan.

46. The Language Assistance Plan involves a center, located in Southern California, which houses operators who provide Spanish translation services for "0" operators, repair service, and special operator services, as well as bilingual directory assistance service. The plan will eventually develop similar services for Asian-speaking customers, if economically feasible.

47. The Hispanic Market Plan involves statewide employment of bilingual service representatives, increasing the availability of Spanish language emergency and dialing instructions in directories, and more involvement with local Hispanic business communities.

48. Pacific Bell has made a corporate decision to provide high quality bilingual services because it believes the economics of such an undertaking are promising.

49. All active parties now believe that Pacific Bell's programs should be approved by this Commission. Even U.S. English has apparently dropped its opposition. The only issue of

controversy is whether the Commission should maintain an oversight role.

50. While approving the plan as an indication of our approval of the general direction Pacific Bell is pursuing in this area, it is appropriate for the Commission to maintain an oversight role given (a) its longstanding concern about the adequacy of bilingual telephone service and the (b) great number of ratepayers who will be affected by these programs.

51. Pacific Bell has complied with this Commission's requirement in D.84-06-111 that it meet with authorized representatives of recognized minority groups and thereafter submit in this proceeding an F/MBE tracking procedure.

52. Pacific Bell has complied with this Commission's requirement in D.84-06-111 that it establish F/MBE goals for 1986 and include them as a part of this rate case filing.

53. AB 3678, addressing F/MBE procurement, was enacted by the Legislature subsequent to the hearings on this issue.

54. AB 3678 became effective on January 1, 1987.

55. This Commission instituted OIR 87-02-026 to implement the requirements of AB 3678.

56. The frequency and manner of required F/MBE reporting and eligibility verification, the basis for establishing goals and timetables, and the content of guidelines for establishing F/MBE programs are all issues being addressed in the OIR.

57. Pacific Bell claims that its 1986 test year budget for F/MBE was $1,068,500.

58. Pacific Bell decided to build SRV to house its administrative work force in order to reduce the costs of housing those workers in leased office space, and to achieve the benefits of consolidating its scattered administrative work force in one location.

59. An economic study performed in 1981 underlies Pacific Bell's claim that SRV results in ratepayer savings of $200 million.

60. The 1981 calculation of savings was accomplished by subtracting the present value of the revenue requirement associated with owning SRV ($428 million) from the present value associated with the leasing alternative ($634 million); as part of this calculation, Pacific Bell added a FIN ADJ adjustment, to compensate for the fact that its leasing cash flows were discounted at the cost of money instead of the cost of debt.

61. A dispute has arisen between DRA and Pacific Bell over FIN ADJ, since DRA believes the academic justification for FIN ADJ has no direct applicability to ratemaking; DRA relies instead on an analysis of whether there is additional financial cost associated with leasing that translates into a ratepayer cost.

62. Pacific Bell demonstrated, however, in several restudies of the original 1981 study that even with FIN ADJ, SRV was still cost-effective in varying measures.

63. Pacific Bell reassessed its original decision to construct SRV in light of the softening rental market, and at the time it broke ground in April 1983, had decided to upscale the project to include more of its work force than originally planned.

64. Pacific Bell has demonstrated that the decision to proceed with construction of SRV in 1983 was reasonable.

65. The fast track construction method chosen for SRV has certain advantages associated with acceleration of the timetable for start of construction and compression of the project delivery time. The time savings in the case of SRV were approximately two years.

66. Using fast track construction methods, and in view of events occurring subsequent to the 1981 SRV studies but prior to ground breaking in April 1983, Pacific Bell decided to upscale SRV to its present size, rather than build it in phases. This allowed for consolidation of more of its administrative work force at SRV than original plans had contemplated.

67. The decision to employ the fast track method required careful management oversight of the construction process, including the change order process.

68. The S&W contract was a percentage fee contract with a cap on both the fee and the field office overhead. The fee percentage is 1.25% of construction costs up to a $2.2 million maximum. Field office overhead is limited to a stated maximum of $3.3 million.

69. Although the S&W contract contained no explicit incentive clauses, it did contain some implicit economic incentives.

70. A majority of actual construction costs were arrived at by a competitive bid process.

71. S&W's compensation for its own subcontracting efforts was limited to reimbursement for actual labor, direct supervision, and material costs excluding any overheads, profits, and management service fee.

72. It is presently unclear whether the S&W fee arrangement has been renegotiated, in view of total SRV costs, and if so, under what terms. Thus our review of the reasonableness of the S&W contract pertains only to its impact on the SRV costs recognized in Phase 1. The actual status of the S&W fee arrangement vis-a-vis present SRV costs (i.e., those in excess of the Phase 1 authorized level) is a matter for review at the time rate recognition of those costs is requested.

73. The record demonstrates that the SRV Project Management Team put adequate procedures in place designed to ensure management control, review, and scrutiny of the project, including an extensive system of review of change orders.

74. The record demonstrates that change orders are a particular area of concern in controlling the costs of a project constructed under the fast track method. DRA's audit of the change order process was limited in scope and did not cast reasonable doubt on Pacific Bell's expert testimony which termed the process "exhaustive and fully controlled." Nonetheless, for purposes of

future rate recognition of amounts over the Phase 1 authorized rate recovery, a careful examination of all change orders relative to these additional amounts is merited.

75. Today's order confirms the reasonableness of the specific SRV related costs recognized in Phase 1, since Pacific Bell's management of SRV construction costs appears to have been adequate, at least in relation to those costs.

76. All we have before us in this proceeding is the $230 million originally requested for SRV. We have not reviewed costs over this $230 million, due to test year constraints. At the appropriate future time, Pacific Bell must make its case if it wishes to reflect the additional SRV construction costs in rates.

77. It is appropriate to require Pacific Bell to retain all data associated with its tracking of SRV costs, to assist in any future review we may undertake of SRV costs exceeding those currently reflected in rates.

78. The current attrition formula for labor attrition fixes productivity at a constant rate; if the utility exceeds this rate, its stockholders may retain the difference.

79. DRA's proposed productivity incentive plan, as modified herein, is designed to stimulate infrastructure productivity increases, and compensate for the difficulty of gauging overall productivity gains with reference to constant rates which serve as mere benchmarks for purposes of the attrition year.

80. In general terms, DRA's proposal involves a 50-50% ratepayer/shareholder sharing of productivity gains over 3.5% for 1987 and 1988 attrition years.

81. Pacific Bell prefers a zero productivity adjustment (1.0%) unless the Commission adopts its suggested revisions (Exhibit 174) to the generic attrition mechanism, in which case it supports a modified version of DRA's proposal.

82. In D.86-12-099 we responded to Exhibit 174, modifying the attrition mechanism in part, but not totally as Pacific Bell

wished; in that decision we also mandated a 5% productivity rate for the 1987 attrition year, rather than the 1.0% requested in Exhibit 174. Pacific Bell has appealed D.86-12-099, challenging these actions.

83. A 2.9% productivity rate is appropriate for use in conjunction with the incentive mechanism, given the evidence that levels above 3.5% are sustainable until the early 1990s.

84. There is no demonstrable need for requiring Pacific Bell to split its 50% share of amounts exceeding the 2.9% figure between shareholders and an employee bonus plan fund, given Pacific Bell's existing programs to encourage employee productivity.

85. Given current ratemaking conventions, there is no need to explicitly adjust Pacific Bell's authorized rate of return upward to allow it to retain benefits over this amount, attributable to the workings of the incentive plan.

86. CPIL's suggested productivity indices was not presented on the record, and the impact of its adoption was not addressed by the parties.

86a. DRA's suggested productivity index is access lines per employee, an industrywide measure. As such, ALPE is preferable as a tool for measuring productivity to the labor costs/access line index suggested by Pacific Bell.

87. DRA's recommendation that Pacific Bell be required to adopt a competitive bidding plan for all COSE purchased for cutover after October 1988 (similar to that required of General Telephone) is unnecessary, given the fact that Pacific Bell's current program is designed to identify a pool of three qualified vendors, while at the same time allowing the utility to retain flexibility vis-a-vis product selection by location.

88. Due to an incomplete record of the post-settlements effects of shifts in access billings, D.86-01-026 designated for further review in Phase 2, the test year industrywide effects of

shifts in revenue requirements from access services to exchange services (SPF to SLU effects).

89. Subsequent to issuance of D.86-01-026, DRA sent DR 900-6 to all ICOs to obtain the information necessary to assess these industrywide SPF to SLU effects. DRA's revenue requirement recommendations are based on analysis of the information provided by the ICOs in response to DR 900-6.

90. DRA's recommended negative $9.368 million true-up for interLATA SPF to SLU shifts is rooted in settlement base data and settlements data obtained in response to DR 900-6. As such, it represents precisely those industrywide impacts we wished to explore in Phase 2, and is reasonable for adoption.

91. Pacific Bell's recommended $11 million offset to DRA's recommended negative $9.368 million true-up, keyed to its access service settlements payment to General Telephone, is not a direct component of the interLATA access pooling issue, which is before us in Phase 2; therefore it is not appropriate for adoption.

92. DRA's recommended $14.099 million revenue requirement adjustment, derived from information provided by ICOs in response to DR 900-6, recognizes the effects of the interLATA SPF to SLU shift on EAS expenses, not calculated in D.86-01-026. As such, it is designed to capture a further industrywide impact of the interLATA SPF to SLU shift, and is reasonable for adoption.

93. DRA's recommended $23 million revenue requirement adjustment associated with mutually agreed-upon modifications to the separations factors (Exhibit 617, p. NCL-3) is reasonable, given our adoption of those agreed-upon modifications.

94. Pacific Bell's $43.4 million revenue requirement associated with the agreed-upon modification to the separations factors is not reasonable for adoption, since it uses 1985 recorded separations factors as a base, rather than the 1986 factors developed in Phase 1, which were premised on 1984 recorded separations factors.

95. The negative $72.540 million revenue requirement adjustment associated with the true-up of the intraLATA pool is premised on DRA's review of ICO data indicating that test year intraLATA toll revenues would be substantially higher than those adopted in D.86-01-026, where 1983 data was used without review or challenge. Adoption of this adjustment is reasonable, given our desire to assess industrywide SPF to SLU impacts on Pacific Bell's revenue requirement more precisely in Phase 2, and in the interests of fairness to ratepayers.

96. The test year revenue requirements impacts of two FCC separations rule changes, effective June 1, 1986, are undisputed and reasonable for adoption. The impact of the FCC's Account 645 rule change is $14.268 million; the impact of the FCC's rule change regarding direct assignment of closed end WATS is negative $24.418 million.

96a. Moving from a Subscriber Plant Factor (SPF) cost allocator to a Subscriber Line Usage (SLU) cost allocator for intraLATA toll will provide a more consistent cost policy and a more appropriate reflection of cost "causation."

96b. The means of moving from a SPF allocator to a SLU allocator for intraLATA toll may require reevaluation or adjustments in the future to assure reasonableness.

96c. WATS lines are dedicated to a single use and their costs should be directly assigned to that use.

97. The revenue requirements impact of adoption of DRA's intraLATA SPF to SLU proposal is agreed to be negative $12.078 million.

98. The request for an additional $6.397 million in revenue requirement associated with the ICO High Cost Fund was effectively withdrawn on June 2, 1987 in the "Joint Supplemental Brief - High Cost Fund Issues" filed in this proceeding.

99. The revenue requirements impact of adoption of the ZUM expansion proposal is negative $15.088 million.

99a. The criteria Pacific applied in determining its proposed ZUM expansion are appropriate.

100. The test year revenue requirements impacts of advice letters is a negative $45.5 million, rather than the negative $39.6 million provisionally recognized in Phase 1.

101. No evidentiary record exists to enable us to assess the reasonableness of increasing the test year revenue requirement in the amount of $11.545 million to recognize the "settlement impact of surcharge elimination from pooling." (Exhibit 754, Table A, line 8.)

102. Pacific Bell is presently subject to a $45.2 million penalty for underutilization of its central office and outside plant facilities, in the form of a halving of the effective rate of return on the plant at issue (D.83-12-025 and subsequent related orders).

103. The threshold levels for removal of this penalty, established at the time the penalty was imposed, are 91.5% (central office) and 67.6% (outside plant).

104. The record demonstrates that Pacific Bell has exceeded the threshold level of 91.5%, and that the $31.4 million underutilization penalty relative to central office equipment should be removed, as of March 5, 1986 (the effective date of D.86-03-049, the order denying rehearing of D.86-01-026), as specified in D.85-09-085.

105. The DRA-initiated TCE audit demonstrated the existence of more excess pairs in addition to the 106,500 excess pairs upon which the present $13.8 million underutilization penalty for outside plant is based. Based on this fact, and the results of the TCE audit which showed an increase in the utilization level to 66.3%, still short of the required 67.6% that would trigger penalty removal, DRA recommends an additional $21.8 million penalty, for a total penalty of $35.6 million.

106. Pacific Bell accepts the 66.3% utilization level, short of the 67.6% that would trigger removal of the outside plant penalty, but argues that the overall $35.6 million penalty recommended by DRA should be reduced to $4.1 million.

107. Pacific Bell's $4.1 million recommendation is premised on a differing unit cost per available pair than that adopted in D.83-12-025, but Pacific Bell has failed to provide specific information in support of its unit cost figure keyed to its criticisms of the types of plant included in the penalty adopted in D.83-12-025, or to provide an analysis of the acceptability of utilization of those types of plant (distribution, public requirements, etc.).

108. DRA has failed to justify its recommendation for an additional $21.8 million outside plant underutilitization penalty, given the criticisms levelled by Pacific Bell, as more particularly discussed in the text of this order.

109. Given the data base problems noted by TCE, it is reasonable to condition removal of the $13.8 million outside plant underutilization penalty on an independent audit, to be conducted by a firm selected by DRA, which shall also manage the audit.

110. There is no disagreement that the $13.8 million outside plant underutilization should be lifted as of the date that the independent audit establishes that Pacific Bell has met the 67.6% standard.

110a. A generic utilization study should be performed by a consulting firm selected by DRA, as recommended in Exhibit 570 (paragraph 14), and Exhibit 701, designed to recommend work procedures and computer procedures which will optimize utilization and reduce costs, as well as to recommend data reporting procedures which will enhance DRA's monitoring abilities on a continuing basis.

111. The goal of consistent utilization measures in all states is a worthwhile undertaking, since post-divestiture we have

lost the ability to compare Pacific Bell's performance with the performance of comparable utilities in other states.

112. DRA has recommended an incentive/penalty forecast mechanism, more fully described in the text of this decision, designed to improve wire center forecasts of access lane gains, and thereby improve plant utilization for the future.

113. While acknowledging the innovative nature of the mechanism, Pacific Bell has many specific criticisms of the fairness of the forecast mechanism, which persuade us that the proposal is not ready for adoption in its present form.

114. CBCHA has highlighted the issue of the reasonableness of existing levels of "ready to serve" plant, both from the perspective of pre-building and response time to service order requests, in light of its estimate of the nearly $350 million annual cost of such plant to Pacific Bell's ratepayers.

115. Pacific Bell has demonstrated that 40% of its total customer churn is accommodated by ready-to-serve plant.

116. Pacific Bell has argued the merits of the pre-build concept and response time considerations, in opposition to CBCHA's position, although the record contains conflicting evidence on these points, insufficient to resolve the two issues.

117. Given the state of the record, as noted in the preceding finding, and Pacific Bell's showing on the churn issue, we are unwilling to adopt CBCHA's Phase 2 recommendations for a macro study and accounting procedures at this time, although CBCHA is free to raise the issue in the context of our review of the SRI and A.D. Little modernization studies.

118. The appropriate standard for regulatory oversight of relationships between a utility and its affiliates is that of ratepayer indifference. Ratepayers should neither be harmed nor advantaged by the relationships between a utility and its affiliates.

119. The evidence did not support the allegation that there is a flow of intangibles between the regulated utility and the holding company affiliates adversely affecting ratepayers that cannot be adequately remedied via pricing mechanisms and other adopted Commission requirements.

120. The evidence shows that many intangible benefits can be identified and priced by reference to market data, such as in the case of referrals and employee transfers.

121. The evidence does not support the adoption of the 5% royalty payment proposal. The standard of ratepayer indifference can be assured through other regulatory requirements upon Pacific Bell's relationships with Pacific Telesis and the Pacific Telesis subsidiaries.

122. The 25% employee transfer fee recommended by the auditors, and set at 25% of the transferred employee's starting salary, represents a realistic measure of an approximation of the market value of benefits received by affiliates associated with such transfers at this time, since it focuses on the costs avoided by the affiliates as a result of obtaining employees from the regulated utility. As such it is superior to the present 10% fee, which is keyed to Pacific Bell's costs, rather than the market value of the benefits conferred on the affiliate.

123. The 13% referral fee recommended by the auditors as an adjunct to current transfer pricing of referrals, represents a realistic measure of an approximation of the market value of referrals from the regulated utility to the PacTel affiliates at this time, in the absence of an affirmative showing by the opposing parties supporting their allegations of flaws in the methodology underlying the recommendation. The fee is premised on 13% of sales revenues resulting from Pacific Bell referrals.

124. In order to best protect ratepayers, it is appropriate to periodically review the effectiveness of Commission-imposed restrictions and guidelines dealing with relationships between

Pacific Bell, Pacific Telesis, and the various affiliates and subsidiaries.

125. The appraisal of the 420 Cowper Street property should have been premised on the figure of $2,250,000, to include the impact of inclusion of $250,000, which was excluded from the appraisal due to an improper downward negotiation of the property's value by Pacific Bell prior to its sale to PacTel Properties. The resulting gain, to be credited to Account 174, is $1,202,590.

126. To clarify that the Commission will have access to relevant books and records held by Pacific Bell's joint ventures, it is appropriate to adopt SDO condition 2 as modified to indicate only that PU Code § 314(b) applies to such joint ventures.

127. To provide the Commission with an opportunity to act before an asset transfer becomes final, it is appropriate to adopt SDO condition 8, requiring Pacific Bell to notify the Commission at least 30 days before transferring any asset with a fair market value of more than $100,000 to an affiliate or to Pacific Telesis. Such notification is not necessary for transfers of funds undertaken in the operation of a cash management system. To protect Pacific Bell's interests, such notificaton may be designated to be proprietary informaton subject to the usual protections against disclosure.

128. To assist the Commission in monitoring transactions between Pacific Bell and its affiliates, it is appropriate to adopt a modified version of SDO condition 11 to require Pacific Bell to notify the Commission when an affiliate purchases transmission services from Pacific Bell. For administrative convenience, it is appropriate to permit such reports to be aggregated and presented quarterly.

129. To protect ratepayers from any financial risk following from investments in affiliated businesses, it is appropriate to adopt SDO condition 14 to prohibit Pacific Bell from guaranteeing the notes, debentures, debt obligations or other securities of

Pacific Telesis or of its subsidiaries and affiliates without prior written permission from the Commission.

130. No parties advocated SDO conditions 1, 6, 7, 19, or 20. It is not necessary to adopt any of them.

131. SDO condition 18 pertains to affiliate royalties, and is not necessary given our other findings regarding royalties.

132. SDO condition 3 pertains to transfer pricing, and is not necessary given our other findings and guidelines regarding transfer pricing.

133. SDO condition 4 addresses appropriate accounting practices, and is unnecessary given our more detailed investigation into the Uniform System of Accounts in I.87-02-023.

134. The Commission expects that Pacific Telesis and affiliate personnel will appear before the Commission as is necessary without subpoena. If problems in this regard develop, the Commission will impose such conditions as are necessary to ensure the proper exercise of the Commission's full regulatory authority.

135. SDO condition 9 is duplicative of auditor Lew's recommendation adopted in this decision as Ordering Paragraph 34(e).

136. SDO conditions 12, 13, 15, and 16 seek to assure adequate capitalization of Pacific Bell through an appropriate capital structure. Other Commission authority, such as the ablity to impute an appropriate capital structure for ratemaking purposes, is adequate to achieve this objective.

137. SDO condition 10 would not be administratively practical for Pacific Bell to implement on a universal basis.

138. SDO condition 17 would be required only if Pacific Bell had developed a financial or other interest in an affiliate. The development of such an interest would be of concern regardless of

whether such an affiliate were to be divested. Other Commission-imposed guidelines and authority would be sufficient to protect ratepayers in such a circumstance.

139. Retention of the $4 million revenue requirement adjustment to ensure cooperation by Pacific Bell and PTG during the conduct of the further Phase 3 audit, is necessary based upon our experience in Phases 1 and 2, as previously discussed.

140. A follow-up report on the effectiveness of the entire set of Commission-imposed guidelines and restrictions regarding Pacific Bell's relatonship with its affiliates and with Pacific Telesis will help to protect ratepayers by providing a basis for refining these guidelines and requirements to reflect further experience.

141. Based on the evidence in this proceeding, the guidelines and restrictions put in place by this and prior orders will combine with the ongoing exercise of Commission oversight to protect ratepayers from suffering any harm due to Pacific Bell's relationships with Pacific Telesis and its affiliates and subsidiaries.

142. The recommendations for imposition of specific other requirements and guidelines made by the auditors, and set forth in Section XIII.C.1 (paragraphs 1 through 21) of this opinion will assist in our review of the transactions between Pacific Bell and the affiliated companies.

143. Ordering Paragraph 1(a) of D.86-03-049 provided as follows: "Pacific Bell's...intrastate rates and charges shall be collected subject to refund back to March 5, 1986 in view of the further reductions in revenue requirements which could result depending on the outcome of issues to be addressed in the next phase of these proceedings."

144. D.86-01-026, mimeo. pp. 5-6, detailed several precise issues to be addressed during Phase 2, thus defining the scope of evidentiary hearings to be conducted during Phase 2, in order to

provide assurance that Pacific Bell's rates authorized as a result of the instant application are reasonable.

145. Pacific Bell's rates following the issuance of the interim order were designated subject to refund solely in connection with the issues so defined for Phase 2 review.

146. Some issues reserved for Phase 2 review, which have been reviewed in Phase 2, require further record development, and are deferred to Phase 3.

147. The revenue requirement reductions ordered herein, as shown in Appendix B, and subject to further refund as a result of Ordering Paragraph 36, are reasonable.

148. Pacific filed AL 15325 to reflect the 1988 SPF to SLU transition. The amount of industrywide shift in revenue requirement is $101.1 million which changes the billing surcharge/surcredit on other than access services by an increment of 1.81% and on access services by an increment of negative 0.427%.

149. As shown by Table 1 the reduction in Pacific Bell's revenue requirement for all other issues addressed in this decision for the year January 1, 1988 through and including December 31, 1988 is $194,471,000, which changes the billing surcharge/surcredit adjustment for access sevices and other than access services by an increment of negative 3.29%.

150. Consolidating AL 15325 with this decision will reduce customer confusion in that only one change in billing surcharge/surcredit will occur on January 1, 1988. This new billing surcharge/surcredit for other than access services is negative 0.193%, and for access services is negative 9.080%.

151. D.85-06-113 dated June 12, 1985 directs AT&T-C to flow through any reduction in its access expense stemming from reductions in local exchange utilities' access charges to its customers.

Conclusions of Law

1. We take official notice, pursuant to Rule 73, of the final rules and regulations relative to interest synchronization, published in the Federal Register on May 22, 1986 (51 FR 18775).

2. TURN's motion to overrule the ALJ's ruling allowing Pacific Bell to expand its showing to address the impacts of the underutilization penalty and the Remand Case Closing Agreement, should be denied, since the ruling did not prejudice the rights of other parties to address these issues.

3. Interest synchronization should be adopted as an adjustment to Pacific Bell's test year revenue requirement, as shown in late-filed Exhibit 754, but adjusted to reflect adopted Phase 2 results, in order to effectuate a more equitable sharing of ITC benefits between investors and ratepayers.

4. The reduction to Pacific Bell's test year revenue requirement, to account for adoption of interest synchronization, should date from March 5, 1986, the effective date of D.86-03-049 which provided that intrastate rates and charges "shall be collected subject to refund back to March 5, 1986," in connection with our review of designated Phase 2 issues.

5. Pacific Bell should be ordered to continue its CNP refund program and to commence a second notification campaign, in accordance with today's order.

6. Pacific Bell should be ordered to proceed with current lifeline outreach efforts, in accordance with today's order.

7. TURN's motion for a Commission order finding Pacific Bell in contempt of D.86-05-072, should be denied.

8. TURN's $100 million penalty recommendation and its proposed Consumer Advocacy Trust Fund, should be rejected in accordance with the preceding discussion.

9. DRA's $49.5 million penalty recommendation should be rejected, in accordance with the preceding discussion.

10. A variation of Public Advocates' "educate the ratepayer" penalty recommendation should be adopted, in the amount of $16.5 million, for the limited purposes specified in today's order.

11. The CMOC should be established, to fulfill the mandate it was given in D.86-05-072, and to operate in accordance with the proposed charter, Appendix C hereto, until May 30, 1989, unless its term is ended sooner by Commission order.

12. Pacific Bell should be ordered to revise its Tariff Rule 12 in accordance with DRA's recommendations (Exhibit 589, Appendix C).

13. Having addressed Rule 76.54(a)(2)-(4), Public Advocates should be found eligible from compensation for its efforts on the marketing abuse issue on behalf of LULAC, based on our determination in D.86-01-006 that it had satisfied the "significant financial hardship test" (Rule 76.54(a)(1) on behalf of LULAC in this proceeding.

14. Having addressed Rule 76.54(a)(2)-(4), Public Advocates should be found eligible for compensation for its efforts on the marketing abuse issue on behalf of CAA; even though CAA was not covered by D.86-01-006, Public Advocates was found in D.86-11-079 to have satisfied the significant financial hardship test (Rule 76.54(a)(1) on behalf of CAA for calendar year 1986; therefore, pursuant to Rule 87, and given our intention in D.86-01-006 to relieve Public Advocates of the burden of reestablishing significant financial hardship on behalf of its designated clients every year in this protracted proceeding, CAA's satisfaction of the Rule 76.54(a)(1) test in D.86-11-079 should be deemed applicable to this proceeding, regardless of its duration.

15. This Commission should approve Pacific Bell's bilingual plan reviewed in these hearings, as an indication of its approval of Pacific Bell's general direction in this area; however, the Commission should also maintain continuing oversight in the bilingual services area.

16. Reporting requirements should be adopted, as set forth below, in furtherance of the Commission's oversight role.

17. R.87-02-026 is the appropriate forum for determining the frequency and manner of required F/MBE reporting and eligibility verification, the basis for establishing goals and timetables, and the content of guidelines for establishing F/MBE programs for all utilities subject to the provisions of AB 3678, including Pacific Bell.

18. No credible evidence established that Pacific Bell's 1986 test year budget for its F/MBE program would not be $1,068,500.

19. The ultimate burden of proof of reasonableness of the SRV related costs for which Pacific Bell seeks rate recognition is on Pacific Bell.

20. Pacific Bell has presented clear and convincing evidence of the reasonableness of the SRV-related costs recognized in Phase 1 of this proceeding, and the record supports no reduction of the Phase 1 cap.

21. The Phase 1 SRV cost cap should be retained.

22. Until further order of this Commission, Pacific Bell should be required to retain all data associated with its prior tracking of SRV costs, to assist any future Commission review of SRV costs exceeding those currently in rates.

23. DRA's productivity incentive plan should be adopted for attrition years 1988 and 1989, as modified by the provisions of today's order.

24. DRA's proposal regarding competitive bidding for central office switching equipment should not be adopted.

25. DRA's recommended net $44 million revenue requirement decrease (Exhibit 754, Table A, lines 1 and 2) in recognition of the test year impacts of the true-up of the interLATA and intraLATA settlement pools, based on the industrywide impacts shown in ICO data, should be adopted.

26. The agreed test year revenue requirements impacts of the FCC's Account 645 rule change and its WATS rule change, as reflected in Exhibit 754 (Table A, lines 3 and 4), should be adopted.

27. The revenue requirements impact of adoption of DRA's intraLATA SPF to SLU proposal (a negative $12.078 million) should be reflected in the Phase 2 results of operations.

28. The revenue requirements impact of adoption of the ZUM expansion proposal (a negative $15.088 million) should be reflected in the Phase 2 results of operations.

29. An additional negative $5.9 million revenue requirement impact should be reflected in Phase 2 results of operations, to account for advice letter adjustments.

30. Pacific Bell has the burden of proof relative to removal of the present $45.2 million underutilization penalty.

31. The $31.4 million underutilization penalty relative to central office equipment should be removed as of March 5, 1986, as required by D.86-03-049 and D.85-09-085, Ordering Paragraph 4.

32. Pacific Bell has failed to meet its burden of proving that the $13.8 million outside plant underutilization penalty should be reduced.

33. The removal of the $13.8 million outside plant underutilization penalty should be premised on the findings of an independent audit establishing that Pacific Bell has met the 67.6% standard imposed in D.83-12-025. Said penalty should be lifted as of the date this fact is established by the independent audit.

33a. Within 6 months of the effective date of this order or 2 months from completion of the generic utilization study, whichever is later, Pacific Bell should submit to the directors of DRA and CACD a report detailing how it will manage future utilization, given the generic utilization study conducted pursuant to this decision.

34. The DRA 5% royalty proposal should be rejected for the reasons previously discussed.

35. The 25% employee transfer fee proposal of the DRA auditors should be adopted in accordance with the preceding discussion and relevant finding.

36. The 13% referral fee recommended by the DRA auditors should be adopted, consistent with the preceding discussion and relevant finding.

37. The land sales adjustments recommended by the DRA auditors should be adopted consistent with the preceding discussion and finding.

38. In lieu of previous credits to Accounts 360 and 171, Pacific Bell should be ordered to credit $1,202,590, to Account 174, Other Deferred Credits, in connection with the sale of the 420 Cowper Street property to PacTel Properties.

39. As a partial adoption of SDO condition 2, Pacific Bell and PTG should be ordered to comply with PU Code § 314(b) in regards to any joint ventures into which they may enter.

40. As an adoption of SDO condition 8, Pacific Bell should be ordered to report to the Commission any pending transfer to PTG or an affiliate or subsidiary of any asset with a fair market value of $100,000 (one hundred thousand dollars) or greater. This report should take place at least thirty days prior to the date of such transfer.

41. As a partial adoption of SDO condition 11, Pacific Bell should be required to report to the Commission any purchases by PTG or its affiliates or subsidiaries of telecommunications transmission services from Pacific Bell. Pacific Bell should be authorized to aggregate these reports into a quarterly submission.

42. As an adopton of SDO condition 14, Pacific Bell should be ordered not to guarantee any notes, debentures, debt obligations or other securities of Pacific Telesis or its subsidiaries and affiliates without prior written permission from the Commission.

43. Consistent with the prior discusson and relevant finding, the Commission's CACD and DRA staff divisions should be ordered to prepare a follow-up report describing Pacific Bell's experience with its affiliates.

44. The $4 million revenue requirement adjustment should remain in place for Phase 3, pending completion of the DRA audit on joint ventures, strategic alliances, and R&D projects.

45. The revenue requirement reductions ordered in this decision apply as of March 5, 1986, (the effective date of D.86-03-049) pursuant to Ordering Paragraph 1(a) that decision. This action does not violate the ban against retroactive ratemaking, because D.86-01-026 and D.86-03-049 made Pacific Bell's rates subject to refund within the specified parameters of our Phase 2 review of very narrowly defined issues, and the reductions ordered in today's decision flow directly from that defined review.

SECOND INTERIM ORDER

IT IS ORDERED that:

1. Pacific Bell's test year revenue requirement is hereby reduced, consistent with the preceding discussion, to account for adoption of interest synchronization, from and after March 5, 1986.

2. Pacific Bell shall develop and test further informational and corrective customer notification/refund measures and undertake a second customer notification plan (CNP) campaign in concurrence with the workshop participants, without necessity of prior confirmation by this Commission. Within 30 days from the effective date of this order, Pacific Bell shall meet with the workshop participants to provide results of the so-called Customer Communications Trial effort, and to begin developing a further plan for the second CNP campaign. Twenty days prior to actually undertaking the second CNP campaign, Pacific Bell shall file a compliance filing with the Docket Office (with service on all

parties of record) briefly outlining the details of this second effort. All costs and expenses associated with the activities noted in this ordering paragraph, as well as Ordering Paragraph 3, shall be borne by Pacific Bell's shareholders, consistent with the ratemaking treatment ordered in D.86-08-026.

3. Nine months after commencement of the second CNP campaign, Pacific Bell shall file a compliance filing with the Docket Office (with service on all parties of record) reporting the results of the second effort, including total refunds made, and any tracking of results that has been undertaken.

4. The workshop/CNP mechanism shall continue as a vehicle to address those marketing abuses covered by D.86-05-072 until further Commission order; however, 30 days after Pacific Bell files the compliance filing required by Ordering Paragraph 2, the workshop participants shall make a joint filing with the Docket Office (with service on all parties of record) containing their recommendations relative to terminating the workshop/CNP mechanism.

5. Toward Utility Rate Normalization's (TURN) motion for an order finding Pacific Bell in contempt of D.86-05-072 is hereby denied.

6. Within 30 days of the effective date of today's decision, Pacific Bell shall charge an appropriate nonoperational expense account in the amount of $16.5 million, and set that amount aside in a special interest bearing account, pending establishment of a legal trust designed to further the goal of ratepayer educational efforts, as broadly defined in earlier portions of this decision. Contemporaneously, Pacific Bell shall inform the Director of CACD by letter of the precise actions it has taken in compliance with the preceding directive. Thereafter, we intend the following matters to occur:

a. Within 60 days of the effective date of today's decision, Pacific Bell shall submit to the Director of CACD a final draft of a trust instrument, which is designed to carry out the terms of the ratepayer

education fund provided in this decision. (We encourage Pacific Bell to share earlier drafts with the CACD director, in order to expedite our review.) At the same time, Pacific Bell shall inform the Director of CACD in writing about the steps it has taken to address our criteria that the trust conform to I.R.C. § 501(c).

b. CACD should confer with the Legal Division if it believes changes to Pacific Bell's final draft are necessary prior to submitting the final language to us. Nonetheless within 60-90 days after the events outlined in subparagraph 6a have transpired, CACD shall prepare a resolution which details the final trust terms, including the identity of the financial trustee (who is to be chosen by CACD) and the disbursements committee members. After we have signed the resolution and the legal trust has been established in accordance with the terms of the trust instrument, Pacific Bell will pay the $16.5 million, previously set aside pursuant to Ordering Paragragh 6, plus any accrued interest, into the legal trust.

c. Immediately following issuance of today's order, and during pendency of the events outlined in Ordering Paragraphs 6a and 6b, the Public Advisor shall meet with representatives of Pacific Bell and DRA, and obtain their assistance and cooperation in soliciting two consumer groups for membership on the disbursements committee, in accordance with the guidelines set forth in the text of this decision. The Public Advisor shall make recommendations to us as soon as reasonably possible, and before the establishment of the trust, for filling these two committee positions, based on the criteria set forth in this decision.

d. In carrying out the provisions of Ordering Paragraph 6, Pacific Bell and CACD shall reflect the Commission's intent that the ratepayer education trust fund, a legal trust separate and apart from Pacific Bell's books of account, operate at a

minimum with the following provisions and safeguards:

(i) The goal shall be disbursement of $3 million annually, to promote ratepayer education efforts, over the next five years. The balance remaining at the end of year five shall be disbursed in year six (Ordering Paragraph 6(f)).

(ii) Decisions regarding disbursements shall be made by a committee composed of representatives of Pacific Bell, DRA, two consumer groups (chosen by the Commission, in accordance with Ordering Paragraph 6c), with each commitee member having one vote. If the committee is unable to make a decision on a particular disbursement, or its members are otherwise deadlocked, the Commission's Public Advisor shall seek to mediate the dispute, with the authority to cast a deciding vote, if necessary.

(iii) The disbursements committee shall meet annually each year to make disbursements decisions, based on proposals presented by its members. The financial trustee shall thereafter make the disbursements in accordance with the decisions reached at the annual committee meeting.

(iv) In no event shall any disbursements made, or proposals presented for consideration, directly benefit any of the voting members. We are especially concerned that disbursements not further Pacific Bell's marketing programs or corporate profit motives, and that they not duplicate, directly or indirectly, programs covered by authorized commercial expenses.

(v) The financial trustee shall file with the Commission's Executive Director annual accountings at the end of each calendar year of the trust's existence, indicating (i) the amounts disbursed during the preceding calendar year (and to whom), and (ii) account or trust balances as of the same period. A final accounting shall be made reflecting the final disbursement of

the trust balance after the year six disbursement.

(vi) The financial trustee shall disburse the balance remaining in the trust fund at the end of five calendar years during year six on the same basis as the preceding five calendar years, at which time the trust will terminate.

7. The Customer Marketing Oversight Committee (CMOC) is hereby established to operate pursuant to the overall mandate it was given in D.86-05-072, and according to the proposed charter, Appendix C hereto, with special emphasis on the lifeline, telemarketing, and sales quota issues discussed previously in this decision. The CMOC chairperson shall submit reports as necessary in his/her discretion, in this docket, in the form of compliance filings (with service on all parties); 30 days after expiration of CMOC's term, the chairperson shall submit a final report containing a summation of CMOC's findings, conclusions, and recommendations. CMOC's term shall end on May 30, 1989, unless the Commission provides for an earlier termination by subsequent order.

8. Within 30 days of today's order, Pacific Bell shall file an advice letter, with service on all parties of record, containing revisions to its Tariff Rule 12, implementing the revisions contained in Appendix D hereto, to become effective 30 days after filing.

8a. On or before December 31, 1988, Pacific Bell shall file an advice letter, with service on all parties of record, containing its proposal for implementing itemized billing for its business customers, to be effective by January or February 1989.

9. Public Advocates, representing the League of Latin American Citizens and Chinese for Affirmative Action, is eligible for compensation for its work on the marketing abuse issue in this proceeding, regardless of the proceeding's duration beyond 1985.

10. On June 30 and December 31 of each calendar year, commencing with June 30, 1988, Pacific Bell shall submit semi-annual written reports to the Director of E&C, and contemporaneously shall serve copies of such reports on all parties listed on the service list of this proceeding. This requirement shall continue until further order of this Commission. Such reports shall contain, for each six-month period:

a. A complete narrative of progress made, and problems encountered, relating to multilingual service.

b. Special statistics relating to the number of customers served by language, geographic area, and type of service, such as repair, billing, and operator services.

c. A copy of any recommendations made by the Bilingual Consumer Advisory Council, or any successor group, on multilingual services, during the period in question.

11. Pacific Bell's proposed Female/Minority Business Enterprise (F/MBE) budget for test year 1986 in the amount of $1,068,500 is adopted.

12. Based on the record developed in Phase 2, the maximum amount which Pacific Bell shall book to plant in service for building costs in connection with SRV is $230 million, exclusive of land costs; ancilliary IDC shall be derived in view of this cap on building costs. Pacific Bell shall retain all data associated with its prior tracking of SRV costs, until further order of this Commission.

13. DRA's productivity incentive plan is hereby adopted, with the following modifications:

a. A productivity factor of 2.9% is adopted for attrition year 1988; this factor will be used also for attrition year 1989, unless otherwise ordered.

b. The labor attrition formula should be recomputed after the attrition year using the

actual realized productivity factor. If the actual realized productivity factor is less than or equal to 2.9%, the incentive plan described below will not go into effect for that year.

c. The productivity indices to be used in measuring the incentive reward, in the 1988 and 1989 attrition filings, is ALPE, an industrywide measure favored by DRA. This indices shall be used in Pacific Bell's January 30, 1988 attrition filing, ordered by D.87-10-075.

d. The incremental dollar amount computed (as verified by E&C staff) shall be disbursed in the following proportions: 50% shall be refunded back to ratepayers in the form of a uniform surcredit and 50% to Pacific Bell.

14. DRA's recommended net $44 million revenue requirement decrease which recognizes the test year impacts of the true-up of interLATA and intraLATA settlement pools, based on industrywide impacts reflected in ICO data, is hereby adopted.

15. The agreed test year revenue requirements impacts of the FCC's Account 645 rule change and its rule change relative to the closed end of WATS are hereby adopted.

15a. Each exchange telephone company which is a party to this proceeding shall implement the transition in allocation of non-traffic sensitive (NTS) costs to intraLATA toll services prescribed in the foregoing Opinion, gradually converting from use of an allocator based on SPF to one based on SLU through seven annual steps beginning in Janaury 1986 and continuing in January of each year thereafter until and including January 1992. Within 60 days of the effective date of this Order each exchange carrier offering intraLATA WATS service shall make an Advice Letter filing under the terms of GO 96-A to revise the appropriate tariffs to implement a flash cut conversion to direct assignment of closed end intraLATA WATS line costs and to implement an intraLATA billing surcharge on local exchange services, exclusive of intraLATA toll to offset the

lost intraLATA toll settlement effects due to the SPF to SLU transition and the WATS phase-down. Thereafter each exchange telephone company shall make an Advice Letter filing under the terms of GO 96-A in coordination with each annual adjustment in its NTS cost allocator, in order to establish or revise its billing surcharge on intraLATA services, excluding intraLATA toll, using the newly effective NTS cost allocator.

15b. Each carrier rate review during the SPF to SLU phase-down period shall include a review of the reasonableness of proceeding with the phase-down and a consideration of any changes to cost assignments which might be needed.

16. The revenue requirements impact (negative $12.078 million) of DRA's intraLATA SPF to SLU proposal is hereby adopted for inclusion in the Phase 2 results of operations.

17a. Pacific's ZUM expansion for the San Francisco - East Bay Extended Area is granted. Within 90 days of the effective date of this order Pacific shall make an Advice Letter filing under the erms of GO 96-A to amend the appropriate tariffs for implementation of the ZUM expansion described in this decision.

17b. The revenue requirements impact (negative $15.088 million) of the ZUM expansion proposal is hereby adopted.

18. The additional revenue requirement impact (negative $5.9 million) associated with DRA's Phase 2 review of advice letter impacts is hereby adopted.

19. The $31.4 million underutilization penalty relative to central office equipment is hereby removed, as of March 5, 1986.

20. Within 90 days of the effective date of this order, DRA shall select a consultant for the purpose of evaluating the costs and benefits of a full scale versus statistical independent audit of outside plant utilization, in accordance with the terms of this decision. After this initial evaluation is complete, DRA shall select an independent auditor and manage the primary audit as more fully discussed in this decision. This primary audit shall be

triggered by the filing of the Pacific Bell application seeking removal of the $13.8 million penalty.

21. Pacific Bell may file an application seeking removal of the $13.8 million penalty, effective as of the date of certification by the independent auditor that it has met the 67.6% outside plant utilization standard. Pacific Bell shall include in this application its own variation of the forecast mechanism presented by DRA in Exhibits 568 and 569, designed to address the utilization issue prospectively, so that these issues may be heard in one proceeding.

21a. Within 6 months of the effective date of this order, or two months after completion of the generic utilization study, whichever is later, Pacific Bell shall submit to the Directors of DRA and CACD a report detailing how it will manage future utilization, given the results of the generic utilization study conducted pursuant to this decision. Pacific Bell shall also provide copies of this report to the parties actively litigating modernization and utilization issues in this proceeding.

22. The Executive Director shall take whatever action he deems appropriate to ensure that NARUC is apprised of this Commission's concern that consistent utilization measures be adopted in all states, given the post-divestiture difficulties of comparing such measures on a utility-by-utility basis.

23. The DRA 5% royalty recommendation is not adopted, based on this record.

24. The DRA recommended 25% employee transfer fee proposal is hereby adopted,consistent with the preceding findings of fact and conclusions of law.

25. The DRA recommended 13% referral fee proposal is hereby adopted, consistent with the preceding findings of fact and conclusions of law.

26. Pacific Bell shall credit $1,202,590, to Account 174, in lieu of its previous entries to Accounts 360 and 171, in connection

with the sale of the 420 Cowper Street property to PacTel Properties.

27. The auditors shall continue their audit of affiliated transactions, to review strategic alliances, R&D projects, and joint ventures, in accordance with the preceding discussion, findings of fact and conclusions of law.

28. Pacific Bell and PTG shall comply with PU Code § 314(b) regarding any joint ventures into which they have entered or may enter.

29. At least 30 days prior to its occurrence, Pacific Bell shall report to the Commission the pending transfer to PTG or an affiliate or subsidiary of any asset with a fair market value of $100,000 (one hundred thousand dollars) or greater.

30. Pacific Bell shall report to the Commisson any purchases by PTG or its affiliates or subsidiaries of telecommunications transmisson services from Pacific Bell. Pacific Bell is authorized to aggregate these reports into a quarterly submission.

31. Without prior written permission from the Commission, Pacific Bell shall not guarantee any notes, debentures, debt obligations or other securities of Pacific Telesis or its affiliates or subsidiaries.

32. Consistent with the prior discussion and relevant finding, the Commission's CACD and DRA staff divisions are ordered to prepare a follow-up report describing Pacific Bell's experience with its affiliates.

33. The $4 million revenue requirement adjustment imposed in Phase 1 to ensure cooperation with the audit, shall remain in place until completion of our review of DRA's audit.

34. The DRA audit recommendations (Section XIII.C.1, paragraphs 1 through 21) are adopted to facilitate further review of affiliated transactions:

a. Pacific Bell and/or its parent Pacific Telesis Group shall take all necessary steps to inform the auditors of

organizational changes in the structure of PTG.

b. Pacific Bell shall undertake to perform cost benefit studies in future transactions involving the regulated Mobile Companies and their affiliates, to insure that data is available to allow the auditors to assess the merits of these affiliated transactions (Exhibit 619, p. 4-15).

c. Pacific Bell shall not transfer rights to its properties to the unregulated affiliates at less than an independently appraised fair value. Such appraisals should take into consideration the relationship of the party exercising the option to Pacific Bell and the value of the property if Pacific Bell should vacate the property.

d. Pacific Bell and/or PTG shall notify the auditors of all future sales of Pacific Bell and PGT properties to PacTel Properties.

e. Pacific Bell shall track the movement of former Pacific Bell employees to and from affiliated companies and shall report such movement to the Commission on an annual basis by submitting such information to the director of the Commission's CACD every December 31.

f. The PacTel Companies should provide quarterly reports on intercompany personnel movement to the auditors. Pacific Bell and/or PTG shall take all steps necessary to effect this guideline.

g. Pacific Telesis Group shall reinstate Section 3 of "Pacific Telesis Group and Subsidiary Policy [for] Salaried Employees." This section requires the PacTel Companies to track all intercompany movement.

h. Pacific Telesis Group shall keep the auditors informed of all future changes to corporate guidelines regarding

relationships or transactions between Pacific Bell, PTG, and their affiliates and subsidiaries.

i. Pacific Bell and/or PTG shall arrange to require that all bills from Pacific Bell to its affiliated companies shall be paid directly to Pacific Bell rather than through PacTel Corporation, in order to maintain a clear audit trail.

j. PTG shall ensure that all transactions with Pacific Bell are tracked through the affiliates' accounting systems.

k. PTG and Pacific Bell shall take all steps necessary to ensure that referrals from Pacific Bell to the affiliates are tracked, and totals reconciled on a monthly basis.

l. Pacific Bell and PTG shall take all steps necessary to ensure that the affiliates continue to pay Pacific Bell for the cost of referrals on a transfer-priced basis so that Pacific Bell will recapture the total cost of providing the referrals.

m. PTG shall take all steps necessary to ensure that separate revenue accounts are established by each affiliate to book revenue received from customers referred by Pacific Bell.

n. Pacific Bell and Communications shall track and centrally file all customer RFPs, Pacific Bell's replies, and affiliate companies' replies to all sales contracts and RFPs in which the customer has chosen Communications as the vendor.

o. PTG shall develop guidelines and reporting requirements on intercompany personnel movements. Reports shall be provided to the auditors quarterly, beginning on June 30, 1988, and shall contain the information recommended by the auditors in Chapter 15 of Exhibit 619.

p. Pacific Bell shall develop guidelines regarding release and disclosure of

proprietary information and intellectual properties to the affiliates. The guidelines shall be provided to the auditors in sufficient time to allow for meaningful review prior to their implementation.

q. PTG and Pacific Bell shall take all steps necessary to ensure that Pacific Bell and PacTel Companies track referrals made by Pacific Bell to affiliates. Referrals shall be tracked in accordance with the auditors' recommendations in Chapter 15, Exhibit 619.

r. PTG and/or Pacific Bell shall ensure that copies of all filings made by the affiliates with the FCC, DOJ, and Judge Greene, copies of all Opinions, Orders, and Rulings issued in regard to these filings, and copies of all civil complaints filed against the nonregulated affiliates are provided to the auditors on an on-going basis.

s. PTG shall take all steps necessary to ensure that the PacTel Companies maintain a subsidiary ledger for all intercompany transactions. The ledger should be tested and reconciled to Pacific Bell's books by the Telesis Internal Auditors and the results of the audits should be provided to the DRA auditors.

t. Pacific Bell and PTG shall take all steps necessary to ensure that Pacific Bell, Pacific Telesis Group and PacTel Companies retain all internal and external correspondence under Pacific Bell's current policy until such time as the auditors and the company determine a required retention period.

u. Pacific Bell shall continue to develop a study on the market prices of its transfer-priced services. Pacific Bell shall offer DRA opportunities to review and comment upon drafts of this study prior to its completion.

35. The revenue requirement reductions flowing from today's order apply as of March 5, 1986, pursuant to Ordering Paragraph 1(a) of D.86-03-049, consistent with the preceding findings of fact and conclusions of law.

36. Pacific Bell's intrastate rates and charges shall remain subject to refund back to the effective date of D.86-03-049 in view of the further reductions in revenue requirements which could result depending upon the outcome of the specified issues originally reserved for Phase 2 review, to be further addressed in the next phase of these proceedings.

37. Within five days of the effective date of this order Pacific Bell shall file revised tariff sheets to reflect the incremental changes in billing surcharge/surcredit adopted in this decision. The effective date of the ordered revisions shall be January 1, 1988. Such filing shall comply with General Order Series 96-A.

38. AT&T Communication of California (AT&T-C) is ordered to collect the access charge reductions it receives as a result of this decision into a memorandum account, with interest, at the appropriate 3-month commercial paper rate. The reductions will be passed through to AT&T-C's customers by a further order of the Commission.

This order is effective today.

Dated December 22, 1987, at San Francisco, California.

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

I will file a written partial dissent.

/s/ DONALD VIAL
Commissioner

APPENDIX A

Additional Appearances

Applicant: Thomas Ballo and Ronald R. McClain, Attorneys at Law, for Pacific Bell.

Intervenor: Yolanda Vera, for LULAC, Public Advocates.

Interested Parties: Diane Elan Wick and Barnaby W. Zall, Attorneys at Law, for U. S. English; Sid Wolinsky and Robert Gnaizda, Attorneys at Law, for Intervenors Minority Coalition; James B. Gordon, Jr., for Communications Workers of America, District Nine; Richard Odgers, Robert M. Ralls, and Walter J. Sleeth, Attorneys at Law, for Pac Tel Corporation and Pac Tel Mobile Companies; Thomas A. Gutierrez, Deputy City Attorney, City of Los Angeles; Margaret deB. Brown, Attorney at Law, for Pacific Telesis Group; Ruth MacNaughton, Attorney at Law, for AT&T Communications of California, Inc.; Frederick E. John, David B. Follett, Peter N. Osborn, Glen J. Sullivan, Jr., Attorneys at Law, for Southern California Gas Company; Stephen A. Edwards, Attorney at Law, for San Diego Gas & Electric Company; and Rita Schuman, Attorney at Law, for herself.

(END OF APPENDIX A)

PACIFIC BELL
Adopted Separated Summary of Earnings
Test Year 1986
($000)

		Total Company	Inter-State	IntraState					
				Total	Access	IntraLATA			Exchange
						Total	MTT	PL	
		(a)	(b)	(c)=(a-b)	(d)	(e)=(f+g)	(f)	(g)	(h)=(c-d-e)
	OPERATING REVENUES								
1	Local Revenues	2,811,174	0	2,811,174	0	0	0	0	2,811,174
	Intrastate								
2	Access Revenues	1,359,296	0	1,359,296	1,359,296	0	0	0	0
3	Toll Revenues	1,898,103	0	1,898,103	0	1,898,103	1,691,561	206,542	0
4	Interstate Access Revenues	1,858,049	1,858,049	0	0	0	0	0	0
5	Miscellaneous Revenues	851,782	0	851,782	0	0	0	0	851,782
6	Attrition	(16,534)	0	(16,534)	(10,667)	(13,165)	(13,165)	0	7,414
7	LESS: Uncollectibles	75,832	0	75,832	0	23,344	23,344	0	52,488
8	Total	8,686,038	1,858,049	6,827,989	1,348,629	1,861,594	1,655,052	206,542	3,617,882
	OPERATING EXPENSES								
9	Maintenance	1,776,863	433,222	1,343,641	239,531	388,285	312,808	75,477	715,825
10	Traffic	259,194	13,637	245,557	13,701	79,089	79,074	15	152,767
11	Commercial	834,118	73,570	760,548	44,876	120,780	103,764	17,016	594,892
12	General Office Sal. & Exp.	489,180	90,293	398,887	52,985	106,673	93,509	13,164	239,229
13	Other Operating Expenses	847,984	143,314	704,670	81,075	204,621	179,703	24,918	418,974
14	Subtotal	4,207,339	754,036	3,453,303	432,168	899,448	768,858	130,590	2,121,687
15	Depreciation	1,370,203	318,143	1,052,060	175,124	291,448	240,507	50,941	585,488
16	Taxes Other than on Income	343,129	71,688	271,441	39,518	71,589	59,664	11,925	160,334
17	State Income Tax	217,335	58,622	158,713	62,307	48,989	49,560	(571)	47,417
18	Federal Income Tax	804,706	222,222	582,484	252,860	184,277	191,862	(7,585)	145,347
19	Total	6,942,712	1,424,711	5,518,001	961,977	1,495,751	1,310,451	185,300	3,060,273
20	Net Revenues	1,743,326	433,338	1,309,988	386,652	365,843	344,601	21,242	557,609
	RATE BASE								
21	100.1 - Tel Plt in Serv	19,710,466	4,660,016	15,050,450	2,504,299	4,058,074	3,316,897	741,177	8,488,077
22	100.3 - Prop Held for Future Use	14,935	3,467	11,468	1,848	3,015	2,453	562	6,605
23	Materials & Supplies 122	90,109	20,917	69,192	11,150	18,193	14,799	3,394	39,849
24	Working Cash	298,352	55,097	243,255	31,575	61,004	51,463	9,541	150,676
25	LESS: Depreciation Reserve	4,212,752	1,008,743	3,204,009	533,371	846,992	712,104	134,888	1,823,646
26	LESS: Deferred Tax	2,854,849	686,271	2,168,578	367,287	593,605	486,083	107,522	1,207,686
27	Total	13,046,261	3,044,483	10,001,778	1,648,214	2,699,689	2,187,425	512,254	5,653,875
28	RATE OF RETURN	13.36%	14.23%	13.10%	23.46%	13.55%	15.75%	4.15%	9.86%

NET-TO-GROSS and REVENUE REQUIREMENT

	1.00000
Uncollectible rate	0.01101
Difference	0.98899
CCFT @ 9.6%	0.09494
Difference	0.89405
FIT @ 46%	0.41126
Difference	0.48279
Net to Gross Multiplier	2.07131

****

ADOPTED INTRASTATE REVENUE REQUIREMENT
($000)

Adopted Intrastate Rate Base	$10,001,778	
Adopted Rate of Return	0.1252	
Net Intrastate Revenues Adopted	1,252,223	
Net Revenues at Present Rates	1,309,988	
Change in Net Revenues	(57,765)	
Revenue Requirement = Change in NR * NTG	($119,650)	<<<<
	============	

Miscellaneous Revenue Requirement Adjustments:

Phase I -		
Affiliates - Holdback	(4,000)	
Plant Underutilization (D.84-06-111)	(45,439)	
Coin Station (D.85-12-079)	(3,600)	
Advice Letters - New Services	(39,600)	
Gain on Sale of Land to AT&T	(3,312)	
Subtotal - Phase I Misc. R.R. Adjustments	($95,951)	
Phase II -		
ZUM Expansion	(15,088)	
Advice Letter Adjustments	(5,900)	
Plant Underutilization	31,639	
Telesis Audit	(3,203)	
Female/Minority Business Enterprise	1,069	
Subtotal - Phase II Misc. R.R. Adjustments	$8,517	
Total Misc. Revenue Requirement Adjustments	($87,434)	<<<<

Total Intratstate Revenue Requirement	($207,084)	<<<<
	============	
Less Phase I Rev. Requirement (D.86-03-049)	($120,649)	
Net Intrastate Revenue Requirement:	($86,435)	<<<<
	============	

(End of Appendix B)

APPENDIX C

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of PACIFIC BELL, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application 85-01-034 (Filed January 22, 1985; amended June 17, 1985 and May 19, 1986
And Related Matter	I.85-03-078 (Filed March 20, 1985)

July 25, 1986

Compliance Filing: Ordering Paragraph 8 of Decision 86-05-072

CUSTOMER MARKETING OVERSIGHT COMMITTEE

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APPENDIX C

CUSTOMER MARKETING OVERSIGHT COMMITTEE

EXECUTIVE SUMMARY

In Decision 86-05-072 the Commission found Pacific Bell guilty of abusive sales marketing practices. Specifically, the Commission found that the utility: (1) violated Public Utilities Code Section 532 by conducting an unauthorized trial program relative to enhanced services; (2) violated Tariff Rule 12 in its "package selling" efforts, failing to properly provide customers with a quotation consisting of a full itemization of recurring and nonrecurring charges applicable to the service and equipment applied for; (3) violated Tariff Rule 6 relative to the establishment and reestablishment of credit, applying the deposit waiver provisions of the tariff inconsistently and failing to give certain customers the benefit of the waiver provisions in accordance with the terms of the tariff; (4) violated Section 1.3.21 of General Order 153, the procedure for administration of the Moore Universal Telephone Service Act, improperly applying the definitional criteria for lifeline service eligibility.

This report is submitted to the Commission in compliance with Ordering Paragraph 8 of Decision 86-05-072 which directs the Evaluation and Compliance (E&C) Division Staff to convene workshops for the purpose of developing a proposal for the establishment of a Customer Marketing Oversight Committee (herein referred to as the Committee). The overall responsibility of the Committee will be to "ensure that Pacific Bell's customer marketing practices, for both residential and business sectors, are brought into conformance with the statutes, orders and other

APPENDIX C

appropriate tariffs on file with this Commission and that appropriate safeguards are put in place by Pacific Bell's management to ensure such conformance in the future" (confer D.86-05-072: 16). Workshops were held on June 30, 1986, July 8, 1986 and July 11, 1986. Participants included representatives from Public Advocates, TURN, Telecommunications International Union--California, Pacific Bell management, General Telephone and the Commission's Consumer Affairs Branch, Public Staff and Evaluation and Compliance Staff (see attachment to the Executive Summary).

For workshop participants the task at hand was to ensure that the Committee's activities are clearly and reasonably focused and that its responsibilities and obligations are sufficiently defined at the operational level. Moreover, a committee structure had to be designed in such a way as to promote the goal of consensus among the Committee members, similar to the productive working relationship developed among the participants in this workshop. Attached is the proposed Charter for the Committee which workshop participants believe outlines the necessary and sufficient conditions to accomplish the three requirements above. The Executive Summary highlights some of the important aspects of the Charter and describes the underlying nature of some the agreements and disagreements that surfaced during the workshop proceedings.

Committee Size and Composition

Workshop participants agreed Committee membership should be inclusive (rather than exclusive) to ensure a mixture of

"experts" in public utility regulation, utility employees and concerned lay persons who are customers of Pacific Bell. The proposed Charter suggests a total of 18 groups from which to base Committee membership. Commission staff and intervenors familiar with tariffs, the PU Code and other Commission rules and regulations should be represented so they can lend their expertise in public utility regulation. It was felt that Pacific Bell management should be respresented because individuals from this category are familiar with a wide range of regulatory issues, in addition to having access to company resources and organizational networks to "make things happen."

Representatives from the Black, Hispanic and Asian communities should be included in the Committee to ensure that the concerns of ethnic minorities are addressed. The Senior Citizen Community, General Business Customers and General Residence Customers should be represented to ensure that the concerns of these population groups are considered and addressed by the Committee. Participation of Pacific Bell's service representatives in the Committee will be crucial since their "hands on" experience will be invaluable during Committee deliberations.

Finally, it is advised that General Telephone and the California Telephone Association (Independent Telephone Companies) should participate in the Committee since they may be, in the future, affected by the Committee's recommendations to the Commission. Moreover, workshop participants believe the Committee will benefit from the active participation of independent telephone companies who will be able to share their

APPENDIX C

thoughts and experiences regarding utility marketing techniques and practices in general. It must be clear, however, that the representation and participation of independent telephone companies in the Committee does not constitute and should not be construed to be an admission by these companies that their marketing practices are or have been in any way abusive.

A list of candidates representing the groups mentioned above is attached to the Executive Summary. Once the Commission has hosen the Committee members, it is recommended that President Vial extend a personal or official invitation to each prospective Committee member (with the exception of staff and Pacific Bell management) not only as a formality but as a way to solicit a high degree of commitment and participation from each individual. Workshop participants are admanant about not having lawyers in the Committee legally representing the various participating groups; it is felt this would make the Committee deliberations unnecessarily cumbersome.

It is important to note that Pacific Bell management has promised to allow service representatives who are members of the Committee to participate in Committee meetings on days they may be scheduled to work and that these service representatives will receive their regular benefits (wages, sick leave and vacation time, travel expenses, etc.) from the utility during those days. The hours spent by service representatives participating in the Committee on behalf of the two unions will not be applied toward the established allotted time for employees' "union activity." There are, however, some issues remaining that workshop

participants did not fully address:

1) Should the service representatives participating on behalf of the two unions receive the regular benefits (wages, sick leave and vacation time, travel expenses, etc.) from the utility for those days they participate in Committee activities or should the unions be responsible for these commitments?

2) Should those representing specifically the Black, Hispanic, Asian, Senior Citizen, General Residence and General Business communities be given a stipend to at least pay for the travel expenses they incur due to their Committee activity? If so, who should be responsible for these commitments? Are stipends crucial in attracting a varied geographical representation in the Committee?

Internal Rules Governing Committee Activity

Simply said, the Committee and its members should be bound by the agreed upon Charter. Workshop participants agreed that all members should be given an opportunity to speak and as a committee body actively strive for consensus whenever possible; it should be the responsibility of the Chairperson (from the Commission's Evaluation and Compliance Staff) to lead discussion with these goals in mind. Moreover, the proposed Charter suggests that the 18 groups representing the various concerns discussed above should each have one vote, regardless of the number of members each group contains. The right to vote in the Committee is therefore respective of group membership. Consequently, although there may be more than 18 regular members in the Committee there only will be a total of 18 votes.

Workshop participants also agreed the Committee should convene as often as required to fulfill its responsibilities. The Chairperson should be responsible for notifying all members one week before the meetings and shall provide Committee members

with the agenda for the meetings in advance. Furthermore, the Committee may not make any final decision unless at least half of the member groups are present during the meeting; no absentee voting should be allowed. It is hoped that these requirments will promote a high degree of commitment and attendance among the Committee participants.

Finally, workshop participants recommend that the Committee only should be a temporary advisory body to the Commission and that it should be dissolved no later than December 31, 1987. Workshop participants strongly believe that the Committee should not be a surrogate for Pacific Bell Management or the Commission Staff.

Scope of Committee Activities

Workshop participants recommend that the following issues should be addressed by the Committee:

(a) business and residence incentive plans for salaried and non-salaried employees;

(b) business and residence quota plans (or similar plans, e.g., goals, objectives, targets, etc.) for salaried and non-salaried employees;

(c) trial offerings of services;

(d) renaming and packaging of services;

(e) administration of deposit practices;

(f) administration of Universal Lifeline Service:

(g) incentive, quota or similar plans in other Pacific Bell organizational entities;

(h) and other matters as determined by the Committee.

Public Staff would like to specifically include "contracts" as a subject for Committee deliberation, since it alleges that

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Pacific Bell violated its tariffs, the statutes and the Commission's General Order in this area of activity. The majority of workshop participants believe, however, that the Committee's activities should be limited to Pacific Bell's marketing and sales practices for several reasons.

First, a substantive record has been developed during Commission hearings regarding only the utility's marketing and sales practices. No record in this instant proceeding exists for the alleged violation by Pacific Bell of Commission rules and regulations pertaining to utility contract activities. Indeed Decision 86-05-072 states that the overall responsibility of the Committee will be "to ensure that Pacific Bell's customer marketing practices (our emphasis), for both residential and business sectors, are brought into conformance with the statutes, orders and appropriate tariffs on file with this Commission...." (confer Decision 86-05-072: 16).

Public Staff argues that the absence of a formal record established for the utility's business sector marketing and sales practices did not prevent the Commission from ordering a notice and refund plan that included the business sector. Public Staff believes that Decision 86-05-072 does not preclude the Committee from investigating Pacific Bell's "contract" activities and that Committee investigation of the utility's violation of any of its tariff schedules, the PU Code and the Commission's rules and regulations would be within the spirit of the decision, since Pacific Bell marketing practices affect a broad range of activities including "contracts." Public Staff therefore argues

that there is no pressing or legitimate reason to limit the Committee's activities.

Workshop participants believe, however, that broadening the Committee's scope of activities any further would only "sap" the limited time, energy and resources available to the Committee which would otherwise be channeled to the specific activities that have been agreed upon in the workshop thus far. The probable success of the Committee will ultimately be based on the quality of its proposals or reports to the Commission, not on the quantity of issues it addresses. To this end, the Committee agreed that residence customer concerns should take priority over general business customers (small business), and the concerns of small business customers should take priority over the larger business accounts.

The majority of workshop participants further believe that "contracts" are very complex and will be of little interest to many Committee members who may be discouraged from attending the meetings. It should be noted that E&C Staff has been working with Pacific Bell on the problems associated with contracts and has extended an invitation to Public Staff to participate in the dialogue. Pacific Bell has also offered Public Staff access to any information it requests from the utility regarding "contracts" in general and in particular. However, Public Staff has chosen to retain its position on this matter.

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It should be noted that James Gordon, Jr., the Director of Governmental Relations for the Communications Workers of America, District 9, was invited to attend the workshop. However, no CWA representative was present during the workshop meetings. Summaries of the workshop proceedings were sent to Mr. Gordon, Jr. to keep him abreast with the issues discussed in the workshop.

RECOMMENDED LIST OF COMMITTEE MEMBERS

(1)	Public Advocates:	Robert Gnaizda or any individual from within the organization.
(2)	T.U.R.N.:	Sylvia Siegel, Jon Elliott or any individual from within the organization.
(3)	Black Community:	David Glover, Oakland Citizens Council for Urban Redevelopment.
(4)	Hispanic Community:	Carlos Melendraz, G.I. Forum
(5)	Asian Community:	Carl Oshira, Consumers Union
(6)	Senior Citizen Community:	Debra Lewis, 998 Praison Lane, Pleasant Hill, CA 94523
(7)	General Residence:	Alice Gates, 1518 Arch Street, Berkeley, CA 94708

APPENDIX C

(8)	General Business:	Judith Bell, Consumers Union
(9)	Service Rep.--TIU:	Alicia Orosco (Residential Telephone Order Center, Shop Steward)
(10)	Service Rep.--CWA:	(Shop Steward appointed by CWA)
(11)	Other PacBell Service Reps.:	(3 appointed by Pacific Bell from a mixture of service organizations: Residence Account Service Center, Sales Development Center, Account Inquiry Center, Major and Priority Accounts. Appointments subject to confirmation of workshop participants)
(12)	Pacific Bell Management:	Del Shull, Glenn Sullivan, Dee Henderson and/or any individual within the organization.
(13)	General Telephone:	Jenny Wong (Regulatory) or any individual within the organization.
(14)	California Telephone Assoc.:	(Appointed by CTA)
(15)	Consumer Affairs Branch:	Tomi Gyotoku or any individual within the organization.
(16)	Public Advisor's Office:	Robert Feraru or any individual within the organization.
(17)	Public Staff:	Dave Shantz or any individual within the organization.
(18)	E & C Staff	Dean Evans and/or Chris Ungson or any individual within the organization.

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CUSTOMER MARKETING OVERSIGHT COMMITTEE

PROPOSED CHARTER

July 25, 1986

APPENDIX C

CUSTOMER MARKETING OVERSIGHT COMMITTEE

PROPOSED CHARTER

Article I

Purpose of Committee

The purpose of the Customer Marketing Oversight Committee (Committee) is to ensure that Pacific Bell's customer marketing practices, for both the Residential and Business sectors, are brought into conformance with the statutes, orders, and effective tariffs on file with the Commission and that appropriate safeguards are put in place by Pacific Bell's management to ensure such conformance in the future. This will be accomplished through the submission of Committee reports and recommendations to the Commission that relate to compliance status.

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Article II

Membership of Committee

The membership of the Committee shall be comprised of representatives from the C.P.U.C. Staff Divisions (Evaluation and Compliance, Public Staff, Consumer Affairs, and Public Advisor), Pacific Bell management and non-salaried employees, customers of Pacific Bell (to include minorities, seniors, and lifeline customers), Toward Utility Rate Normalization, Public Advocates, General Telephone, and the California Telephone Association.

The Committee will be composed of the following eighteen (18) groups, each having one vote:

1. Evaluation and Compliance Staff
2. Public Staff
3. Consumer Affairs Branch
4. Public Advisor Staff
5. Pacific Bell Management
6. TURN
7. Public Advocates
8. Representative for the Hispanic Community
9. Representative for the Black Community
10. Representative for the Asian Community
11. Representative for the Senior Citizen Community
12. Representative for the Small Business customer
13. Representative for the Residence customer
14. Representative from General Telephone
15. Representative from the California Telephone Association
16. Pacific Bell non-salaried employees-(3 non-salaried employees)*
17. Service Representative representing CWA-(1 non-salaried employee)*
18. Service Representative representing TIU-(1 non-salaried employee)*

NOTE: * Pacific Bell's non-salaried employees will be represented by five (5) service representatives: one from an Residence Telephone Order Center (RTOC), one from an Residence Account Service Center (RASC), one from an Sales Development Center (SDC), one from an Account Inquiry Center (AIC), and one representing the priority/major business function.

The service representatives shall provide geographic representation, with no more than 3 representing either the northern or southern portion of the state.

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Article II-Continued

Membership of Committee-Continued

NOTE-Continued

At least one of the selected service representatives shall be selected by CWA and will represent group number 17.

At least one of the selected service representatives shall be selected by TIU and will represent group number 18.

The remaining three service representatives shall be selected by Pacific Bell, subject to confirmation by the workshop participants and will represent group number 16.

Article III

Voting Rights

Each person attending Committee meetings shall have a right to be heard. For purposes of making determinations and establishing quorums, each represented regular membership group shall be permitted one vote. A membership group must be present in order to vote (proxy votes will not be allowed). The purpose of calling for a vote is to end debate. The goal of the Committee is to reach consensus.

Article IV

Committee Chair

The Committee Chairperson shall be a member of the C.P.U.C. Evaluation and Compliance Division. Responsibilities of the chairperson shall include the conduct of all meetings, delegation of sub-committee activities if needed, and the issuance of reports.

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Article V

Meetings

The Committee shall meet monthly or as determined by the chairperson. Meetings will be called with at least a one week notice. Notice will include an agenda. Minutes or meeting notes shall be maintained and distributed to the membership. The committee will amend, as it deems necessary, and approve the minutes or meeting notes at the first meeting subsequent to the meeting in which the minutes or notes were taken. Quorums shall be met if at least half of the regular membership groups are represented. This applies to either the full committee or designated subcommittee's.

Article VI

Term of the Committee

The Committee has been established by Order of the Commission and shall serve until no longer required, as may be determined by subsequent order of the Commission. The Committee shall, in the regular course of its activities, adopt criteria and measurements related to Pacific Bell's customer marketing practices that will enable the Committee to assure itself of the current and future conformance with statutes, orders and effective tariffs. When such criteria and measurements have been in place and consistent results indicating full compliance have been received over a reasonable period (e.g. four to six months), the Committee may recommend to the Commission that the Committee be dismissed. Unless otherwise ordered the Committee shall be dismissed no later than December 31, 1987.

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Article VII

Issues to be Addressed by Committee

The Committee shall investigate and inform itself regarding the following areas of Pacific Bell's customer marketing activities:

1. Business and Residence incentive or similar plans for salaried and non-salaried employees.
2. Business and Residence quota or similar plans for salaried and non-salaried employees.
3. Trial offerings of services.
4. Renaming, packaging or bundling of services.
5. Administration of deposit practices.
6. Administration of Universal Lifeline Telephone Service.
7. Incentive and/or quota or similar plans in other Pacific Bell organizational entities.
8. Other matters as determined by the Commission or the Committee (e.g.; Telemarketing).

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PROPOSED AGENDA

CUSTOMER MARKETING OVERSIGHT COMMITTEE

Introduction of Members

Purpose of the Committee

Committee Charter

Review of Pacific Bell's

- Guiding Service and Sales Philosophy (Attachment 1)
- Suggested Principles for customer marketing practices (Attachment 2)
- Guidelines for handling customer contacts
- Tracking of service and sales results
- Proposed Incentive and quota or similar plans
- Proposed measurement plans

Summation

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Proposed Framework

Pacific Bell proposed and reviewed with the Workshop the Guiding Service and Sales Philosophy and the Suggested Principles for the Customer Marketing Oversight Committee as an illustration of how Pacific would like to operate in an environment that would meet its customer's needs. Pacific believes that the principles would be beneficial as a framework for the Marketing Oversight Committee to use along with the statutes, orders and effective tariffs when reviewing Pacific's Marketing Procedures and Practices before making a recommendation to the Commission.

Guiding Service and Sales Philosophy

Pacific Bell should provide customer satisfaction through top quality service by understanding its customers' needs, offering them choices, and assisting customers to determine what services best match their needs.

Pacific Bell has a special relationship--one of trust--with its customers, which it should honor and continually assure at all times. Serving its customers well will provide it with the best opportunity to sell its products and services.

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CUSTOMER EXPECTATIONS*

SUGGESTED PRINCIPLES FOR THE

CUSTOMER MARKETING OVERSIGHT COMMITTEE

PRINCIPLES FOR CUSTOMER SATISFACTION

-- PERFORMANCE

Pacific should do its job right, know its business, provide follow-up, have effective internal systems, and provide prompt response.

-- EMPLOYEE ATTITUDE

Pacific's employees should be caring, friendly, respectful and not condescending, recognize and/or remember you, and be courteous.

-- ADVOCACY/INVOLVEMENT

Pacific should offer information, look out for the customer's interests, and get the customer what he/she wants.

-- ADVERTISING/SALES

Pacific should not oversell

-- PRICING

Pacific should have reasonable and fair prices, provide good value received for what the customer pays.

-- CONVENIENCE

Pacific should be easily accessible, and in the right locations so it is easy to do business with.

* As expressed in Customer Focus Group interviews.

APPENDIX C

III. MEASUREMENTS OF SUCCESS

— **ARE CUSTOMERS SATISFIED?**

- Do services sold match customer needs?
- Does customer agree that services provide benefits?
- Did we oversell?
- Did the customer get what he/she wanted?

— **ARE CUSTOMERS TREATED WITH RESPECT?**

- Are contacts handled courteously and professionally?
- Were we helpful and responsive?

— **IS INFORMATION WE GIVE TO CUSTOMERS CORRECT?**

- Does customer understand basic service choices?
- Are prices quoted accurately & does customer understand?
- Did customer understand and agree at end of contact? (Assumptive selling is NOT agreement)
- Is written confirmation sent detailing what customer agreed to buy?

— **MEASUREMENT CHARACTERISTICS**

- Both internal and external sources (e.g., both asking customers and internal observations)
- Assess frequency of success
- Assess from a customer viewpoint
- Reinforce desired behavior--excellent customer service
- Indicate nature of corrections needed

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II. CUSTOMER CONTACTS

— THE CUSTOMER MUST BE SATISFIED

- Establish reasonable customer expectations
- Determine with customer which services provide benefits
- Offer only what the customer agrees will provide benefits
- Offer the right products to the right customer (Match unique benefits to unique customer needs)
- Do not oversell--know when to accept customer's rejection (let the customer have full and free choice)
- Be sure the customer gets what he/she wants (escalate if necessary)
- Establish a complete and common mutual understanding of the agreement reached

— THE CUSTOMER IS TREATED WITH RESPECT

- Be professional and responsive
- Be courteous, caring and friendly
- Be the customer's advocate and be helpful
- Apply the "golden rule" (respect every customer)
- Use this opportunity to achieve the customer's confidence in Pacific Bell

— THE CUSTOMER RECEIVES FACTUAL INFORMATION

- Be sure the customer understands basic service options
- Be clear about products and prices
- Services will not be "bundled" without the customer's knowledge (customers will not be misled into buying)
- Rates and charges will be accurately quoted
- Test for clarity of the customer's understanding
- Use extra care to assure understanding when faced with a language or understanding barrier
- Be sure the customer understands fully what has been ordered and agrees before ending the contact
- Follow up the contact with written confirmation

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CERTIFICATE OF SERVICE

I, Gloria Cancilla, certify that the following is true and correct:

I am a citizen of the United States, State of California, am over eighteen years of age, and am not a party to the within cause.

My business address is 350 McAllister Street, San Francisco, California 94102.

On July 25, 1986, I served this report to Administrative Law Judge Carew and all parties in Application No. 85-01-034 by placing true copies thereof in envelopes addressed to the parties as follows:

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which envelopes, with postage thereon fully prepaid. I then sealed and deposited in a mailbox regularly maintained by the United States Government in the City and County of San Francisco, State of California.

Executed the 25th day of July, 1986, at San Francisco, California.

Public Utilities Commission
350 McAllister Street
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By: Gloria Cancilla
Gloria Cancilla

(END OF APPENDIX C)

PROPOSED

RULE NO. 12 - DISCLOSURE OF RATES AND CHARGES AND INFORMATION TO BE PROVIDED TO THE PUBLIC

The rates and charges billed by and paid to the Utility for telephone service shall be the rates and charges legally in effect and on file with the Public Utilities Commission of the State of California. Schedules of rates and charges for services in effect in a particular territory will be kept at all times at a point within that territory where such schedules will be available for public inspection during regular business office hours. A notice, indicating the point at which such schedules are available, will be posted in a conspicuous place in each of the offices of the Utility and the offices of the Utility's agents where patrons receive attention.

In exchanges of the Utility where more than one Type and/or Class of residence exchange access service is offered the Utility, or its authorized employees, must provide each applicant for residence exchange access service, at the time application for service is made, with a full explanation of each such Type and/or Class of residence exchange access service which is available in the exchange for which the applicant is requesting residence exchange access service. The disclosure of available residence exchange services shall include an explanation of Universal Lifeline Telephone Service. Each such explanation of the available residence exchange access services shall include a quotation of the applicable recurring rates and nonrecurring charges applicable to each such residence service.

Where there are additional residence optional services (other than exchange access service) available, the Utility, or its authorized employees, may call applicant's attention, at the time application is made, to the availability of such optional services and the customer may designate which optional services they desire. The Utility shall provide a quotation of the applicable recurring rates and nonrecurring charges applicable to each such service designated by the customer. The quotation of applicable rates and charges shall be stated separately for each optional service designated by the customer.

At the time when a customer requests a move, change or addition to an existing residence service the Utility, or its authorized employees, must provide a full explanation of available residence exchange access service options and optional services in a manner consistent with the provisions of this Rule and must also provide a quotation of the applicable recurring rates and nonrecurring charges applicable to each service requested by the customer.

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At the time of application for business service, or for moves, changes or additions to existing business services, the Utility or its authorized employees shall provide a full itemization of the recurring rates and nonrecurring charges applicable to the services applied for.

Within two working days after the taking of a completed order for new business or residence service or for moves, changes or additions to existing residence or business service, the Utility will mail a confirmation letter to the customer placing the order setting forth a brief description of the services ordered and the specific recurring rates and nonrecurring charges as set forth in the effective tariffs of the Utility which are applicable to the services ordered.

In the event of the adoption by the Utility of new or optional schedules of rates, the Utility will advise those of its customers who may be affected, that such new or optional rates are effective.

In the event a customer desires service in a schedule other than that applicable to their present service, the rates for the new service will be applied on the effective date of the change.

(END OF APPENDIX D)

DONALD VIAL, Commissioner, Dissenting in Part:

As assigned Commissioner, I support the Phase II, Pacific Bell decision with the exception of the change in the ALJ's draft imposed by the majority in the area of affiliate transactions.

Commissioner Wilk's alternative for dealing with affiliate relationships, supported by the majority, misses by a wide margin its declared and lofty purpose of protecting ratepayers and making them indifferent to the existence of holding-company affiliates. The majority's alternative to ALJ Carew's draft order and her evaluation of the record of this proceeding is nothing more than a thinly clad expedient that sweeps a critically important and growing problem under the rug. It does so with a lick and a promise of some vague study to follow. Further, at a critical juncture in the reevaluation of regulatory policy, the majority position effectively sanctions an ominous surrender of PUC regulatory authority over affiliate relationships to the management of Pacific Bell and its parent Pacific Telesis. Moreover, as new technology pushes the monopoly networks of telephone utilities to new frontiers of integrated telecommunications services, the majority approach presages a future where the CPUC will be denied a decisive role in determining how the economic benefits of scale and scope of linking new services to the basic elements of the monopoly local network will be shared between ratepayers and shareholders.

The Driving Force Behind the Majority Approach

It is obvious that the driving purpose behind the majority alternate is to prevent this Commission from directly or indirectly touching the revenue stream of holding company (Pacific Telesis) affiliates. That is the precious authority of this Commission that is being surrendered to utility and holding company management.

The majority approach tries hard to dress up this give-away with a veneer of high sounding commitments to make ratepayers indifferent to what the affiliates are doing. But the bottom line is that the authority to directly or indirectly attach the revenue stream of affiliates is being abandoned under a see-through cloak

of so-called transfer pricing that is supposed to fully protect the utility ratepayers.

The truth is that strong transfer pricing guidelines and standards are necessary, but they are not enough to make the utility ratepayers whole or indifferent. The exercise of Commission authority and responsibility is the threshold issue in protecting ratepayers. There can be no making the utility ratepayer indifferent to holding company affiliates if basic CPUC authority is abandoned--that is, the authority to attach the revenue stream of affiliates when complex utility/affiliate relationships exist and require such attachment.

It is also obvious why touching the revenue stream of affiliates is a "no-no" for the majority position. The abandonment of this authority is the "greaser" for a go-ahead policy to create energy holding companies. This PacBell order is being modified to conform to the framework that is being developed under Commissioner Wilk's guidance to permit the formation of a holding company in the pending SCE case.

<u>Ratepayer Indifference -- the Lumpy Rug</u>

In Finding of Fact 118 Commissioner Wilk and the majority declare:

> "The appropriate standard of regulatory oversight of relationships between a utility and its affiliates is that of ratepayer indifference. Ratepayers should neither be harmed nor advantaged by the relationships between a utility and its affiliates."

The focus is on access to information and the auditing of transactions between PacBell and PacTel affiliates along with the application of transfer pricing guidelines and conditions to "make the ratepayers indifferent." While those guidelines and conditions, including the "identification and pricing" of "many" so called intangible benefits (Finding 120), are deemed by the majority to be fully adequate to protect utility ratepayers from any adverse benefit/cost flows, the basic surrender of CPUC authority over these affiliate relationships is totally ignored. Is the ratepayer "indifferent" to whether or not the CPUC has any

say over when and how a subsidiary should be spawned to engage in activities closely related to activities of the regulated utility or activities involving many intricate benefit/cost flows between the utility and affiliates? Obviously not! Yet that is exactly what is being swept under the rug. Our regulatory rug is going to get so lumpy that no one is going to be able to walk on it.

Why is that? Unlike the energy utilities standing in line to create holding companies, the Pacific Telesis holding company was thrust upon us with the break-up of MaBell and Judge Greene's MFJ. Pacific Telesis does exist. The long record of this proceeding gives testimony to the complexity of existing cost/benefit flows. We are asked to consider policies and conditions to be applied not only prospectively, but to correct major problems that in fact have surfaced and have been specifically identified by DRA auditors. However, up to this point, the Commission still has to confront the threshold question of so-called "ratepayer indifference" which is so warmly embraced by the majority approach. In short, the threshold question is to determine how CPUC authority should be recaptured and exercised to assure an equitable handling of cost/benefit flows between the regulated Pacific Bell and Pacific Telesis affiliates when the activities of the latter involve activities closely related to utility business and/or extensive interchange of services, personnel, technology, and general company know-how.

To illustrate the point, today Yellow Pages is an activity of a subsidiary closely related to the basic services of PacBell. The subsidiary, however, is a subsidiary of PacBell, not Pacific Telesis, and it operates above the line by decision of the CPUC. All profits are included in the earnings of the regulated utility, because the subsidiary is almost like an operating department and because the cost/benefit flows between the subsidiary and PacBell are too difficult to effectively track and separate by any transfer pricing guidelines and other accounting methods.

If the Yellow Pages were being handled by a subsidiary of Pacific Telesis, and thus only an affiliate of PacBell, the earnings of the subsidiary could not be included above the line.

The point is that while Yellow Pages still falls within the CPUC's authority to deal effectively with the threshold question of maintaining ratepayer indifference, there are subsidiaries now functioning under the Pacific Telesis holding company that have varying degrees of relatedness to PacBell's regulated activities. Their earnings are not being reached by the present exercise of CPUC regulatory authority. The affiliates' earnings must be accessible to the CPUC if it is to fairly weigh the relationships of the regulated utility to the affiliates. In this sense, the CPUC's ability to touch earnings becomes a surrogate for the direct control of the flow of costs and benefits between the operating entities. By elevating the means of monitoring transactions to an end in itself, the majority approach frustrates the ability of the CPUC to fully weigh the relationships and prevents the CPUC from effectively exercising the authority that is required to truly attain a standard of ratepayer indifference. In fact, the majority approach would sanction Pacific Telesis' spawning of subsidiaries that are closely related to the regulated functions of PacBell free of any concern that the CPUC may recoup their earnings for ratepayers either directly, as in the case of Yellow Pages, or indirectly, as proposed in DRA's affiliate (so-called royalty) payment approach. In this respect, the majority also sweeps under the rug the basic problem that gave rise to DRA's across-the-board concept of an affiliate payment.

The Difficult to Quantify Affiliate Transactions

The majority does not deny the existence of these difficult to quantify transactions or, as I would call them, cost/benefit flows that may be adverse to the regulated utility and its ratepayers. They simply lump them under the term "intangibles" and assert boldly in Finding of Fact 119:

> "119. The evidence did not support the allegation that there is a flow of intangibles between the regulated utility and the holding company affiliates adversely affecting ratepayers that cannot be adequately remedied by pricing mechanisms and other adopted Commission requirements."

In reviewing the evidence, the ALJ's finding to the contrary is further assaulted by the majority in Finding of Fact No. 120:

> "120. The evidence shows that many intangible benefits can be identified and priced by reference to market data, such as in the case of referrals and employee transfers."

This interpretation of the record boggles the mind. It smarts of some preconceived view about how the complex subject matter of difficult-to-quantify transactions can be swept away. What the record does show is that the auditors uncovered a number of difficult-to-quantify benefit/cost flows that simply cannot be subsumed as readily as portrayed by the majority in Finding 120. That is why DRA, largely out of frustration with time-consuming case-by-case methods, resorted to attaching the revenue streams of affiliates with the advocacy of its 5% across-the-board affiliates payment to Pacific Bell. In this regard, what the record also shows is that DRA's affiliate-payment approach did not discriminate adequately between affiliates and their relationships with PacBell. The various enterprises were lumped together and subjected to a valuation mechanism that was too simplistic. Most important, the record clearly shows that there remains a serious problem for which an adequate remedy is still to be developed or found; not one that can be readily subsumed under transfer pricing rules and other information-oriented conditions preferred by the utilities and embraced by the majority.

The ALJ confronted the issue directly, rejecting the DRA's overbroad remedy, and calling for further hearings to focus more clearly on the dimensions of the issue and the consideration of remedies that give greater weight to the distinguishing characteristics of affiliate relationships. What the ALJ does not do, is to sweep the problem under under rug. The approach advanced by the ALJ is both practical and moderate. It is one that I can wholeheartedly support and that goes at least three-fourths of the way to accommodate valid concerns of the utilities and the majority

viewpoint of the Commission. Specifically, I support the ALJ's call for focused hearings to:

(a) Identify what the potential benefit/cost flows might actually be between affiliates;

b) Determine what the problems are in measuring those cost/benefit flows;

(c) Explore how the magnitude of these flows may be affected by characteristics of an affiliate relationship, i.e., the degree of relatedness of the activities of an affiliate to the regulated functions of the utility affiliate;

(d) Determine the extent to which cost/benefit flows can be controlled by accounting and/or physical separations; and

(e) Develop policy options for dealing with the cost/benefit flows that <u>cannot</u> be handled by accounting or physical separations and audits. (It is in this context that the consideration of affiliate payments or other methods might be ripe for development to control cost/benefit flows that are adverse to the regulated utility).

If the majority does not want to confront the affiliate payment issue in this rational manner (preferring instead a monitoring of the implementation of accountancy standards), there is another alternative that could be adopted now -- an alternative that would be more protective of ratepayers pending the majority's "wait and see" study. We could declare as a matter of policy that when the Commission sees a subsidiary being spawned to engage in activities closely related or linked to the regulated operations of the utility, it will exercise its authority to determine whether that subsidiary is properly placed under PacBell or Pacific Telesis. The Commission's authority to reach earnings of the subsidiary -- as deemed necessary to make ratepayers indifferent to the very existence of the subsidiary -- would be direct when the subsidiary is placed under the regulated utility, PacBell. There would be no

need to employ indirect methods of reaching the earnings of a holding company affiliate to protect ratepayers, because the authority of the Commission over the regulated utility is complete compared to its limited and indirect ability to reach the unregulated holding company and the earnings of its unregulated affiliates.

The Commission could adopt now, in this order, the following policy:

> "On a case-by-case basis, the Commission shall review whether a subsidiary is properly placed under Pacific Telesis or under the regulated utility, Pacific Bell, when the Commission, in such a review, determines that the purpose to the subsidiary is to engage in activities that (a) cannot be carried out without involving the utility's services and personnel in basic ways, (b) require extensive application of transfer pricing mechanisms, and (c) are closely linked to the basic services provided by the regulated utility."

I would go a step further and add:

> "If, upon consideration of these factors the Commission finds that the subsidiary should have been placed under the regulated utility but is not, the Commission shall require the imputation of a percentage of the subsidiary's net revenues, determined on a case-by-case basis, to the revenues of the regulated utility."

This alternative, however, has no acceptance in the majority's limited view of making the ratepayers indifferent to the existence of a subsidiary. Yet, the authority to affect the location of a subsidiary and to reach its earnings directly or indirectly is critical to maintaining the indifference of the ratepayer.

Inadequacy of Majority's Conditions

The majority approach does attempt to substantiate its finding that there is no significant problem that cannot be readily subsumed as proclaimed in Finding No. 119, quoted above. While accepting the ALJ's specific revenue adjustments for reimbursing PacBell for the transfer of employees and property and the provision services to affiliates, the majority goes through the 20

conditions set forth by the Commission in connection with SDG&E's holding company application in an apparent attempt to buttress their concept of "ratepayer indifference." The exercise appears to be one that throws out the important SDO conditions which deal directly with the problems discussed above while embracing weakened versions of several SDO conditions which primarily address the Commission's authority to gain access to certain information about affiliate activities and transactions. These are set forth in the majority's Conclusions of Law 39 to 43. Actually, what the majority provides here is largely what the Legislature has already enacted with the 1985 amendment of Public Utilities Code Section 314, subdiv.(b) and SB 1184 (Stats. 1987, Ch. 1179, adding Public Utilities Code Section 701.5). These measures, respectively, (a) give the Commission broad access to transactions and records dealing with affiliate relationships, and, (b) prohibit PacBell from guaranteeing any notes, debentures, debt obligations and other security of PacTel or its subsidiaries and affiliates without prior written permission of the Commission. In this light, the modified SDO conditions added by the majority take on the flavor of providing "ice in winter." Specifically with regard to a utility backing the debt of a parent holding company or its subsidiaries, there is a longstanding Commission policy prohibiting such backing. Interestingly, the majority doesn't apply the precedent to Pacific Telesis as a matter of policy. The policy is recast as a statute, leaving its application to future decisions on a case by case basis.

Again, it is apparent that the conditions set forth by the majority, based in part on the adoption of several modified SDO conditions, are geared less to expanding or exercising the Commission's existing authority than to establishing a bare-bones and compatible framework in this proceeding for accommodating the holding company interests of the energy utilities.

Implications for the Network of the Future

As indicated at the outset, what we do today with the authority of the Commission over affiliate relationships is of

major importance to sharing the benefits of a modernized operating network. In our relations with the FCC and Judge Greene we, along with the mainstream of regulatory Commissions of other states, have consistently maintained that a universal operating network like PacBell's must grow to be everything that it can be as a least-cost provider of integrated telecommunications services. More specifically, as new services are either attached to or integrated with basic services, we have argued that ratepayers have a major interest in seeing that the economies of scale and scope of the network are captured for all ratepayers, and not just subordinated to entrepreneurial interests. Further we have actively defended the future viability of the operating network and we have insisted upon maintaining the regulatory authority of the states to carry out their responsibilities to the network and its users.

Fundamental to that regulatory authority and responsibility is the exercise of PUC authority to determine how new services should be linked to or integrated with monopoly services. The guts of PUC regulation is to determine whether the costs of providing a new service should be added to the rate base, or whether the new service itself should be provided by a subsidiary and, if so, whether the subsidiary should be under the regulated utility or the unregulated holding company. The price elasticities and competitive nature of the services are critical factors to be considered in determining how the benefits and risks of providing the services shall be shared by ratepayers and shareholders.

The majority's narrow approach to its limited goal of ratepayer indifference in dealing with critical decisions of this nature has ominous implications for the CPUC's role in shaping the network of the future.

The time is now, not later, to confront the realities of affiliate relationships. Those relationships are an integral part of growing the future operating network. Our first obligation is not to accommodate the interests of managers who march to the

diversification drum beat of their Wall Street brethren, but to make sure that the spawning of holding company affiliates does not interfere with the Commission's primary responsibility of equitably distributing the potential benefits of linking up and integrating new services with a monopoly utility.

/s/ DONALD VIAL

Donald Vial, Commissioner

December 22, 1987
San Francisco, California