

Decision 87 12 073

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of)
Pacific Bell for rehearing of)
Resolution T-12007 re revenue)
requirement impact of 1987 attrition.)

Application 87-04-049
(Filed April 24, 1987)

ORDER CORRECTING CLERICAL ERROR

The Commission has been informed of clerical errors, which occurred during the printing of Decision 87-12-048. More specifically, a duplicate line of text was printed at the top of page 21 and at the top of page 23, while the following line of text was dropped from the bottom of page 21: "update issue in D.84-06-111 was rooted in divestiture overlay".

Under Resolution A-4661,

IT IS ORDERED that these errors are corrected, and that the corrected version of D.87-12-048 in its entirety is attached to this order as an appendix.

This order is effective today.

Dated DEC 28 1987, at San Francisco, California.



Victor Weissner
Executive Director

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The ALJ's Proposed Decision was filed and served on the parties on November 17, 1987. On December 7, 1987, pursuant to Rule 77.2 et seq. of the Commission's Rules of Practice and Procedure, Pacific Bell, and DRA filed written comments. In addition, on December 14, 1987, Pacific Bell and DRA filed reply comments. Pacific Bell's reply comments responded to arguments raised in DRA's comments about the propriety of granting a form of relief for 1987, in the absence of specific request for such relief by Pacific Bell.

After reviewing these comments, we have made certain editorial modifications, reflected primarily in Section V, and related findings, *infra*. Other minor editorial changes are found throughout the text (see e.g. Section IV. C.). In addition to these changes, we have made one substantive change in Section V, in recognition of DRA's arguments against a Section "M" filing for the 1987 attrition year. DRA correctly notes that Pacific Bell did not request Section "M" consideration of ELG revenue requirements impacts and argues that such consideration would unduly prolong this proceeding. On reflection, we are persuaded by DRA that we are not required to grant Pacific Bell relief it did not ask for, and that it is time to bring this proceeding to a close. Thus, we limit consideration of Section "M" relief to the 1988 attrition year filing.

II. Procedural Background

In Decision (D.) 86-12-099 we ordered Pacific Bell to make an advice letter filing, covering operational and financial attrition for 1987, in accordance with our established generic attrition formula (sometimes referred to as the "attrition cookbook"). We indicated that we would consider the technical

update of depreciation rates as part of any attrition adjustment¹.

Thereafter Pacific Bell filed Advice Letter 15215 (later supplemented), in which it calculated that the mandated 1987 attrition adjustment would result in an annual revenue requirement reduction of \$75,748,000.² Included in this calculation was an increase in intrastate depreciation expense of \$53,443,000 associated with the technical update.

The Public Staff Division (recently renamed Division of Ratepayer Advocates (DRA)) protested Advice Letter 15215 on several grounds, including the technical update question. DRA contended that Pacific Bell's proposed increased intrastate depreciation expense figure was overstated due to mismatched use of composite accrual rates in calculating the technical update. Our Commission Advisory and Compliance Division (CACD) staff reviewed the advice letter, analyzed the arguments raised in the various protests, and prepared Resolution T-12007 for our consideration.

1 The technical update annually revises depreciation rates by plant category. The rates by category are then combined to compute the so-called composite depreciation rate. According to DRA, because the Commission adopted the remaining life concept years ago, it is necessary to make adjustments annually to reflect changes in the depreciation reserve and to reflect actual life experience in each plant category. This results in an annual updating of the depreciation rates for telephone plant based on weighted average depreciable plant. Historically the annual technical update of depreciation rates is not a finding of reasonableness for ratemaking purposes. (See DRA Brief, p. 3; see also, Resolution T-11098, p. 2.)

2 It is important to note that, while submitting the advice letter as mandated by D.86-12-099, Pacific Bell exercised its right to challenge D.86-12-099 by filing an Application for Rehearing alleging legal error. In D.87-04-078, issued April 22, 1987, we modified D.86-12-099 in certain respects, but denied rehearing. Pacific Bell subsequently filed a Petition for Writ of Review with the California Supreme Court (S.F. No. 25147), and that appeal is still pending.

We issued Resolution T-12007 on March 25, 1987, ordering a reduction in Pacific Bell's gross revenue requirement of \$191,041,000 to account for 1987 financial and operational attrition. The Resolution resolved the technical update protest in DRA's favor, to arrive at a figure of \$10,963,000 to reflect the increase in intrastate depreciation expense due to technical update. This was \$42,480,000 lower than the utility's estimated \$53,443,000 expense figure. The associated revenue requirement impact was \$9,391,000, or \$35,892,000 less than Pacific Bell's estimate of \$45,283,000. Thus, our treatment of the technical update issue resulted in a greater (by \$35,892,000) actual revenue requirement reduction than that estimated by Pacific Bell in Advice Letter 15215.

On April 13, 1987, Pacific Bell petitioned for a stay of Resolution T-12007, seeking to forestall implementation of the attrition-related rate reduction, pending the outcome of its separate formal appeals of the Resolution and the underlying D.86-12-099. On April 22, 1987, we issued D.87-04-077, denying the petition for stay. We did authorize Pacific Bell to record in interest-bearing memorandum accounts the difference between the revenues it actually collects and the revenues it would have collected if the stay had been granted. We noted that these memorandum accounts were designed to help protect Pacific Bell in case any portion of the rate reduction should be overturned.³

³ Thereafter, Pacific Bell applied to the California Supreme Court for a stay pending disposition of its Petition for Writ of Review (S.F. No. 25147), but on April 29, 1987, the Court denied the requested relief, and the attrition-related revenue reductions went into effect as originally scheduled.

Meanwhile, on April 24, 1987, Pacific Bell filed its Application for Rehearing of Resolution T-12007 claiming several legal errors: lack of notice and hearings; lack of proper findings; improper determination of attrition year labor productivity; violation of Pacific Bell's due process rights in handling the depreciation technical update; and violation of the rule against retroactive ratemaking.

On June 15, 1987, we issued D.87-06-022 modifying Resolution T-12007 in certain respects and granting limited rehearing of two issues: technical update and the nonlabor escalation factor.⁴ More specifically, we delineated the scope of this limited rehearing in the ordering paragraphs of D.87-06-022:

"1. The application of Pacific Bell is granted for the limited purpose of receiving evidence and argument concerning what properly should have been included within the "technical update of book depreciation rates" for attrition purposes as ordered by the D.86-12-099 and to determining whether any of the sums requested by Pacific Bell that Resolution No. T-12007 excluded from the Technical Update for Depreciation Expense should be allowed in calculating Pacific Bell's 1987 attrition revenue requirement.

⁴ In D.87-06-022 we did not finally resolve the remaining issues in the Application for Rehearing, indicating that we would address them in this decision.

"2. In this limited rehearing Pacific Bell may also present argument, if it wishes, concerning whether, pursuant to D.86-12-099, the Commission should have followed Pacific Bell's approach to the nonlabor escalation factor, rather than the approach taken in Resolution No. T-12007." (D.87-06-022, mimeo. p. 3.)

On August 27, 1987, a prehearing conference was held in connection with this limited rehearing before Administrative Law Judge (ALJ) Carew. At that time counsel for Pacific Bell stated that the utility did not wish to present additional argument on the nonlabor escalation factor issue. However counsel stated that Pacific Bell wished to present evidence on the labor productivity factor used in Resolution T-12007. DRA and Toward Utility Rate Normalization (TURN) opposed this request. In view of the Commission's precision in defining the scope of the limited rehearing,⁵ the ALJ denied Pacific Bell's request to broaden the issues (PHC Tr. 5:25 - 7:7; 8:15 - 9:16).

Given Pacific Bell's posture on the nonlabor escalation factor issue, and the disposition of its request to expand the issues, evidentiary hearings were held, on October 5 and 16, 1987, limited to the technical update dispute. Pacific Bell presented the testimony of Leonard G. Hebert, its Director - Capital Resource Management - Financial Management. DRA presented the testimony of Senior Utilities Engineer Ramesh Joshi. No other parties presented testimony or other affirmative evidence. Upon receipt of nine exhibits and the filing of concurrent briefs on October 27, 1987, this matter was submitted.

⁵ "The limited rehearing granted herein shall be limited to the two issues specified in ordering paragraphs 1 and 2 above."
(D.87-06-022, Ordering Paragraph 5.)

III. Background of the Controversy over Technical Update

A. Commission Decisions on the Permissibility of Technical Update

In D.84-06-111, our decision determining Pacific Bell's 1984 test year revenue requirement, we discussed the concept of the technical depreciation update in terms of finding new values for (i) the ratio of depreciation reserve to original cost and (ii) the remaining life expectancy of a unit or average remaining expectancy of a group of units. We stated that finding new values for these components was necessary "to reflect changes occasioned by the passage of time, and the passage of time only." (D.84-06-111, mimeo. p. 48.)

We further elaborated:

"As new plant is added, older plant retired, and depreciation accruals are added to the depreciation reserve, the [ratio of depreciation reserve to original cost] will change. Similarly...the remaining life, will change as the average age changes, although the overall determinations of average service life remain the same until a new depreciation study is made. Likewise,...,the future net salvage ratio, will not change until a new value is established in the course of a depreciation study.

"The basic objective of depreciation is the recovery of the cost of plant, less salvage, over the useful life of the property. The remaining life method of depreciation meets this objective, since it provides a rational basis for adjusting depreciation rates so that the cost of the depreciable plant, no more and no less, can be recovered over its useful life. The technical update is an essential part of the remaining life process in that it provides for automatic adjustment of depreciation rates to account for changes in the composition of utility plant and relative growth or decline in depreciation reserve. Without the technical updates, changes to rates resulting from the

three-year represetion of service lives and salvage would also need to include adjustments for three years of changes in depreciation reserve and age distribution of plant. The transitions to new levels of depreciation expense would thus be much more abrupt. Also the deferral of the charging of depreciation expense to a later period, even though the plant has been consumed by current ratepayers, would be unreasonably burdensome and inequitable to later ratepayers." (D.84-06-111, mimeo. pp. 48-49.)

We specifically found in that decision that the technical update of depreciation reserve and remaining life in the context of establishment of an attrition allowance is reasonable.

(D.84-06-111, mimeo. pp. 52-53.) However, we did not specify a method for calculating the technical update, nor did our subsequent decision (D.85-03-042) adopting the generic attrition formula for Pacific Bell and General Telephone Company of California (General) include an explicit discussion of the technical update, or specify how it should be calculated.

In Phase 1 of its current rate case (A.85-01-034), we permitted Pacific Bell to present supplemental testimony suggesting modifications to the generic attrition formula (Exhibit 174, Supplemental Testimony of M. A. Revelle on 1987 attrition). Although Pacific Bell's testimony did not suggest the need to adopt a formula for calculating the technical update, it did request, in view of D.85-03-042's silence on the issue, that we reaffirm our recognition of the technical update concept and its role as part of the attrition mechanism and the remaining life depreciation process.

In D.86-12-099, we addressed the concerns identified in Exhibit 174, and reaffirmed our recognition of the need for technical update, but again, in the absence of a specific request to set forth a formula, we did not specify how the technical update was to be calculated.

B. Actual Practice

The record indicates that the absence of a specific Commission-sanctioned formula did not prevent technical updates from being accomplished in connection with our post 1984 attrition reviews of telephone companies. Those individuals from our staff and from the utilities who actually performed these technical update calculations apparently did so without the benefit of such a specifically delineated formula, and we are not aware that this situation caused any significant problem prior to Pacific Bell's 1987 attrition review. Otherwise we expect some party would have alerted us to the existence of a problem.

In a subsequent portion of this decision we discuss how these calculations were performed for various telephone companies prior to 1987, with specific reference to the actual circumstances, as described by Pacific Bell and DRA in jointly filed Exhibit 4 ("Historical Treatment of Depreciation Technical Updates For Attrition Purposes").

C. Problems in 1987

In its 1987 attrition advice letter Pacific Bell calculated the increase in intrastate expense associated with the technical update at \$53,443,000. It arrived at this figure by calculating a new composite rate of 6.51% based on the technically updated rates adopted by the Commission in Resolution T-11098,⁶ and based on estimated 1987 average Telephone Plant in Service

⁶ Resolution T-11098, issued January 28, 1987, provided for the technical update of straight-line remaining life depreciation rates for all telephone plant, except Circuit and Electronic categories of Central Office Equipment, which use equal life groups, based on estimated 1987 average plant. (Resolution T-12007, Appendix F.)

The reader should be aware that the composite rate figures that appear in Resolution T-11098 differ from those discussed here (and in Resolution T-12007) because items subject to amortization and certain other items have been removed.

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(TPIS). It then subtracted from 6.51% the 1986 adopted test year composite depreciation rate of 6.12% (based on the adopted 1986 plant mix) deriving an increase in depreciation rates of 0.39%. This value, 0.39%, was then applied to the 1987 attrition year adjusted average TPIS of \$17,852,335 to determine the increase in depreciation accruals associated with the attrition technical update: \$53,443,000. This calculation is shown in the following table, extracted from Exhibit 1, which compares the Advice Letter 15215 and Resolution T-12007 treatment of depreciation expense.

Comparison of Advice Letter 15215 and Resolution T-12007
Treatment of Depreciation Expense

1. TOTAL 1987 ATTRITION DEPRECIATION EXPENSE ACCORDING TO PACIFIC BELL

A. Attrition Average TPIS	17,852,335
B. times Composite Rate	0.0651
C. equals Accruals	<u>1,162,187</u>
D. plus Amortizations	356,422
E. equals Total Expense	<u>1,518,609</u>
F. times % Intrastate	0.7676
G. equals Intrastate Expense	<u>1,165,684</u>

2. 1987 DEPRECIATION EXPENSE AS CALCULATED BY ATTRITION FORMULA

Operations Piece

As Pacific Filed As T-12007 Ordered

H. Adopted Average TPIS	17,852,335	17,852,335
I. times Test Year Rate	0.0612	0.0612
J. equals Accruals	<u>1,092,563</u>	<u>1,092,563</u>
K. plus Amortizations	356,422	356,422
L. equals Total Expense	<u>1,448,985</u>	<u>1,448,985</u>
M. times % Intrastate	0.7676	0.7676
N. equals Intrastate Expense	<u>1,112,241</u>	<u>1,112,241</u>

Technical Update Piece

O. New Composite Rate	0.0651	0.0651
P. minus "Old" Comp. Rate	0.0612	0.0643
Q. equals Change in Rate	0.0039	0.0008
R. times Attrition Avg. TPIS	<u>17,852,335</u>	<u>17,852,335</u>
S. equals Accrual Increase	69,624	14,282
T. times % Intrastate	0.7676	0.7676
U. equals Intrastate Expense	<u>53,443</u>	<u>10,963</u>

TOTAL Intrastate Depreciation

V. Operations Piece	1,112,241	1,112,241
W. plus Technical Update Piece	53,443	10,963
X. equals Total Intrastate Exp.	<u>1,165,684</u>	<u>1,123,204</u>

Our CACD staff recommended, and we adopted in Resolution T-12007, an intrastate expense associated with the technical update of \$10,963,000, or \$42,480,000 lower than Pacific Bell's expense estimate of \$53,443,000.⁷ Instead of subtracting the 6.12% composite rate from 6.51%, we subtracted 6.43 from 6.51%, thereby yielding a .08% change in rate, to be multiplied against the \$17,852,335 TPIS figure.

Our rationale for using 6.43% instead of 6.12% and not recognizing the spread between 6.12% and 6.43%, was adherence to the purpose of technical update, which "reflects the change in depreciation expense due to the change in depreciation rates applied to the same year plant mix." (Resolution T-12007, p. 7.) In other words, the spread between 6.12% and 6.43% was due to changes in plant mix⁸ between the Commission-adopted 1986 plant and Pacific Bell's estimate of 1987 average plant. We based the 1986 adjusted composite depreciation rate (6.43%) on the estimated 1987 plant mix identified in Resolution T-11098 because Pacific Bell used that 1987 plant mix in calculating the 6.51% composite rate.

IV. The Evidence Considered in this Limited Rehearing of the Technical Update Issue

A. Introduction

Both Pacific Bell and DRA presented testimony which focused on how the technical update should be reflected ideally in

⁷ As previously stated, the revenue requirement impact of this difference was \$35,892,000.

⁸ A change in plant mix is a change in the relative level of plant contained in the various plant categories; such changes occur in the course of the year due to plant additions and retirements.

attrition adjustments. Both parties presented very different approaches to this question, as discussed subsequently.

The ALJ requested that these parties also prepare jointly filed Exhibit 4 designed to reveal how technical update had been handled prior to 1987. The purpose of this request was to complete the evidentiary record on the factual question whether the Commission's disposition of the technical update in Resolution T-12007 was consistent with prior practice concerning plant mix.

B. Evidence Concerning How Technical Update Should Be Reflected in Attrition Adjustments

1. Pacific Bell's Testimony

Pacific Bell's witness Hebert argues that all of Pacific Bell's "authorized" 1987 depreciation expense should be allowed in the 1987 attrition calculation because this outcome is absolutely consistent with the Commission's recognition that the primary objective of depreciation is the full recovery of the cost of plant, less salvage considerations, over the useful life of the property. Hebert maintains that Resolution T-12007 failed to properly consider depreciation expense associated with a "known"⁹ change in plant mix by failing to consider the spread in composite rates from 6.12% to 6.43%.

Pacific Bell has calculated total 1987 attrition year intrastate depreciation of \$1,165,684,000 in two pieces: (1) the operations piece (which is designed to measure the total attrition year depreciation expense absent any change in the composite (i.e. noncategory specific) depreciation rate between the attrition year and the previous year) and (2) the technical update piece. Pacific Bell maintains that the operations piece cannot reflect changes in

⁹ Review of Resolution T-11098 reveals that the changes in plant mix Pacific Bell refers to are based on estimates of 1987 plant that Pacific Bell filed with the Commission in October of 1986.

depreciation expense associated with a change in composite depreciation rate¹⁰ (Exhibit 1, p. 7), and that the technical update piece must logically be used to recognize such change (6.12-6.43%). In any event, there is no difference in the Advice Letter 15215 and Resolution T-12007 treatment of the operations piece: both reflect an intrastate expense level of \$1,112,241,000; as shown in the previous comparison table, since both are premised on the 6.12% test year composite rate.

In connection with the technical update, however, Pacific Bell maintains that we must reflect the entire increase in the authorized composite depreciation rate from 6.12% in 1986 to 6.51% in 1987 in order to recognize both changes in plant mix and changes in individual category rates holding plant balances constant.¹¹ Furthermore Hebert asserts that because Resolution T-12007 recognized only the change in individual category rates holding plant balances constant (represented by recognition of the 6.43 - 6.51% change), it totally ignored the impact of changes in plant mix on the composite depreciation rate.

Hebert testified that changes in plant mix change the composite depreciation in two ways. First, since each plant category has its own associated depreciation rate, the year over year change in plant mix resulting from different relative levels of net additions (defined previously) causes a change in the composite rate between 1986 and 1987. (Hebert did not quantify this change, however.) Second, the composite rate changes year

¹⁰ We agree that the attrition cookbook precludes recognition of such changes in the operations piece.

¹¹ "Changes in individual category rates holding plant balances constant" were recognized in Resolution T-12007 by recomputing the 1986 composite depreciation rate based on 1987 plant balances.

over year as more plant is added to the plant categories for which Equal Life Group (ELG) treatment was authorized in D.85-08-047.¹²

Hebert identifies two aspects of the ELG impact. First as more plant is added to the two ELG categories in 1987, this alters the total mix (ELG/VG) of plant, since more investment is being depreciated on an ELG basis than in the prior year. As this happens, ELG related depreciation expenses grow relatively larger as a percentage of total depreciation expense. The result is a change to the composite depreciation rate, due to this alteration of total mix of ELG and VG based plant. The second aspect relates to the schedule of stepped rates applicable to ELG vintages by age, as authorized by D.85-08-047. Rates applied to newer vintages of plant are higher in an attempt to ensure full ELG recovery for ELG groups with shorter life expectancies. Hebert illustrated these ELG impacts in Attachment 5, Exhibit 1. At the ALJ's request, Hebert also provided a calculation of the revenue requirement associated with the year-over-year impact of the ELG methodology on total depreciation expense, in connection with this technical update issue: \$17,417,000 (late-filed Exhibit 8).¹³

Hebert's recommendation is that the Commission correct Resolution T-12007 to recognize the additional depreciation expense

¹² In D.85-08-047, we adopted the ELG method of depreciation for the Circuit-Other and COE-Electronic plant categories for 1986 and subsequent vintages (plant additions within a given calendar year). All other plant categories and pre 1986 vintages of Circuit-Other and COE-Electronic categories continue to use the Vintage Group (VG) method.

¹³ In late-filed Exhibit 9, DRA presents its disagreement with Pacific Bell's \$17,417,000 calculation. DRA's alternative calculation is \$7,536 (DRA Brief, Appendix D); however, DRA apparently does not recommend adoption of either of these figures, asserting that the ELG impact is correctly included in the Resolution T-12007 depreciation accrual already (DRA Brief, p. 9).

associated with the change in the composite depreciation rate from 6.12% to 6.43%, reflecting the year-over-year change in plant mix.

In addition, Hebert suggests that, in order to provide full capital recovery, the Commission must grant (i) revenues to offset authorized depreciation expense for 1987; or (ii) a \$42.5 million annual reduction in booked depreciation expense for 1987 for which Pacific Bell claims offsetting revenues have not been provided by Resolution T-12007. He recommends that a reduction of booked depreciation expense (\$42.5 million annually) be authorized for the period from 1/1/87 to the effective date of a Commission decision which corrects for the "underrecovery" problem. On a going-forward basis, Pacific Bell requests allowance of the additional revenue requirement for the unadjusted, currently authorized level of intrastate depreciation expense. Pacific Bell claims that this requires a \$35.9 million annual increase in revenue requirement.

2. DRA's Testimony

DRA's witness Joshi submits that a combined method, which simply develops the total depreciation effect of plant growth and technical update in one step, should be used in lieu of the two step process used in Resolution T-12007. Joshi believes this is consistent with the unwritten practice and consistent with past attrition reviews, with the exception of Pacific Bell's 1984-1985 attrition year review, which deviated from the norm "due to a staff oversight." (Exhibit 2, page 2.) Joshi believes it is advisable to calculate the attrition year depreciation expense using attrition year values for each category of plant and technically updated rates in place of estimating two components, as was done in Resolution T-12007.

Joshi also disputes Pacific Bell's claim that the technical update Resolution (Resolution T-11098) reflects anything more than authorized depreciation rates by plant category. While

Resolution T-11098 also shows estimated increases in the to-be-booked depreciation expense¹⁴ due to the authorized depreciation rates, these are not adopted ratemaking levels. The composite 6.51% uses 1987 estimated to-be-booked plant levels and plant mix which are significantly different from the 1986 ratemaking adopted plant mix. Joshi stresses that:

"Specific adopted rates are not in issue. What is at issue is the need to recognize that the adopted ratemaking depreciation expense will invariably be different from actual booked or estimated to-be-booked depreciation expense due to ratemaking disallowances and the vagaries of estimates used for setting rates in the future. Any attempt to make the ratemaking and the booked depreciation expense level converge is beyond the scope of this proceeding. In any event the correcting mechanism is the true-up effect of the subsequent test year rate proceeding when plant levels and plant mix are once again evaluated for a new base." (Exhibit 2, p. 5.)

In sum Joshi opposes Pacific Bell's 6.12-6.51% composite rate spread and its underlying methodology. He believes the combined method gives a more precise derivation of depreciation and should be used. However, the method used in Resolution T-12007 derives a close approximation, in Joshi's view, considering the magnitude of the total depreciation expense. Joshi's recommended combined method would authorize \$10 million more in depreciation expense, for an associated revenue requirement impact of \$6,498,000 (late-filed Exhibit 7).

¹⁴ Resolution T-11098 (Table A) showed a change in annual depreciation expense of \$14,162,000. This figure was not adjusted to reflect the fact that only a portion of Pacific Bell's plant is devoted to intrastate service.

C. Evidence Concerning the Past Calculation of Technical Update

Joint Exhibit 4 demonstrates how technical updates have been calculated for the major telephone companies subsequent to D.84-06-111. The technical update revisions in question stem from Pacific Bell's 1984-1985 attrition review, General Telephone's 1985 and 1986 attrition reviews, and Continental Telephone's test year 1985 proceeding.

In connection with D.84-06-111 which preceded these reviews, DRA notes that the Commission in that general rate case decision adopted an attrition overlay for Pacific Bell on the post-divestiture 1983 Pacific Telephone base year. D.84-06-111, which incorporated a technical depreciation update, thus included issues unique to divestiture. As DRA notes:

" . . . [T]he plant mix for PacBell was updated from the 1983 plant mix for the 1984 attrition year. However, such an update was appropriate for a full rate case proceeding in the attempt to accurately characterize the newly divested Pacific Telephone plant in its first year of operations. In the context of a full general rate case it was appropriate to review and adjust all appropriate factors especially recognizing that an attrition type overlay was the only practical way to estimate a newly divested entity with no prior recorded data." (DRA Brief, p. 6.)

As the record demonstrates, Pacific Bell subsequently filed for 1984-1985 attrition. In that attrition filing, change in plant mix was reflected in the operations piece of the depreciation calculations. "The change in plant mix was not reflected in the incremental expense associated with Technical Update..." (Joint Exhibit 4, p. 2). However, as this record demonstrates, these are the only two instances in which changes in plant mix were recognized and, in at least one of those instances, the change in plant mix was only recognized as part of the operations piece, not as part of the technical update piece. In its brief, DRA likens these exceptions to "departures from appropriate procedure because

of the extremely unusual necessity to start with a newly divested entity with no recorded prior data." (DRA Brief, p. 7.)

DRA asserts it would be inappropriate to continue to use estimated-to-be-booked mix instead of adopted plant by category (mix) for technical updates. The more appropriate procedure, in its view, is to use adopted test year plant levels by category (mix), the procedure routinely used for General Telephone in the 1985 and 1986 attrition years and for Continental Telephone Company in 1985. (Joint Exhibit 4.)¹⁵

Pacific Bell frames its principal discussion of prior Commission precedents around Joshi's suggested "combined method" for calculating attrition year depreciation expense; in that regard it argues against adoption of Joshi's combined method on the basis that no precedent for that method exists. (Pacific Bell Brief, pp. 19-20.)

Pacific Bell also argues that there is no customary or established method for calculating depreciation expense associated with technical update in the context of attrition. It states:

"These workpapers (Exhibit 4) indicate that different approaches have been used for depreciation expense, including technical update, depending on the individual circumstances involved." (Pacific Bell Brief, p. 19.)

¹⁵ Pacific Bell says that the 1985 Continental review was actually a general rate case decision, which included a reprscription of depreciation rates (D.85-03-057), and that no attempt was made in that decision to quantify a year-over-year change in depreciation expense.

V. Resolution of the Issue

First it is necessary to put our decision in the appropriate framework. Our intent in granting this limited rehearing was not to relitigate prior Commission policy decisions, but rather to consider whether Resolution T-12007 properly carried out the mandates of the December decision (D.86-12-099) in connection with Pacific Bell's 1987 attrition filing (D.87-06-022, mimeo. pp. 1-2).

This is a focused review, which does not contemplate reaching the merits of how the technical update ideally should have been calculated, which unfortunately the parties devoted most of their attention to. Thus, we do not find helpful the policy arguments on "full capital recovery" presented by Pacific Bell, which it advances in support of the argument for recognition of changes in plant mix over and above the adopted base. Citing D.84-06-111, Pacific Bell claims that the Commission has a policy of "full capital recovery". D.84-06-111, actually says: "The basic objective of depreciation is the recovery of the cost of plant, less salvage, over the useful life of the property. . .no more and no less . . ." (mimeo p. 48). However, no one here contends that Pacific Bell should be allowed to recover depreciation on total plant in excess of the figure established by application of the attrition formula, even though Pacific's estimated 1987 plant exceeds that amount. Thus, it is clear that other, countervailing policy considerations temper any policy of "full capital recovery". The language that Pacific Bell relies on, therefore, is not dispositive of the question whether "full capital recovery" should prevail over the Commission's obligation to ensure the reasonableness of changes in plant mix by reviewing them in general rate cases. (Cf. Resolution T-11098: Commission approval of depreciation rates based on 1987 estimated plant "is not a finding of reasonableness for ratemaking purposes".) Citing D.84-06-111,

Pacific Bell further argues that technical update is intended "to account for changes in the composition of utility plant" (mimeo p. 48). However, the quoted phrase is not dispositive of the question whether technical update, in the context of an attrition adjustment, is meant to recognize: (i) only changes in the composition of plant within individual plant categories; or also (ii) changes in plant mix (i.e. changes in the relative level of plant contained in the various plant categories). (Cf. the full discussion of technical update in D.84-06-111 mimeo pp. 48-49.)

Furthermore, we do not consider the merits of Joshi's combined method as a substitute for the cookbook formula. As Pacific Bell notes, consideration of such a change would involve modifying the attrition formula (and the underlying decisions)--a task which is indisputably beyond the scope of this narrowly focused rehearing.¹⁶

The evidence adduced during this limited rehearing demonstrates the fact that there has not been total consistency in our treatment of changes in plant mix, evidenced by our unusual handling of Pacific Bell's divestiture overlay and subsequent attrition review in the immediate post-divestiture environment. There also has not been a definitive formula for calculating technical update. However, the evidence and arguments of the parties show that, even in the absence of such a definitive formula, the approved practice followed by the Commission, with a possible exception, is not to recognize changes in plant mix in the incremental expense associated with technical update in attrition filings. We conclude that any different handling of the technical update issue in D.84-06-111 was rooted in divestiture overlay

¹⁶ Suggestions for changes in the existing formula are appropriate for consideration in I.87-11-033, where we are reviewing alternative regulatory frameworks for local exchange carriers.

considerations. (See, e.g., D.84-06-111, mimeo, p. 43). DRA contends that the Commission's handling of the 1984-1985 attrition filing was caused by departures from normal procedures. It seems reasonable to believe that such departures in the immediate post-divestiture environment led to an unwarranted recognition of changes in plant mix as part of Pacific Bell's attrition review for that year. In any case, as pointed out above, the change in plant mix was recognized as part of the operations piece, and thus does not support Pacific Bell's contention that change in plant mix should be recognized as part of technical update. Moreover, the same decision that passed on Pacific Bell's 1984-1985 attrition request (D.85-03-042) also passed on General's 1985 attrition request. Exhibit 4 shows that General's 1985 technical update was calculated using the adopted plant mix as a base. Similarly, General's 1986 technical update, which resulted in a revenue increase granted in D.85-12-081, issued December 18, 1985, was calculated using adopted plant mix as a base. Thus, in the period immediately preceding issuance of D.86-12-099, our decision confirming the appropriateness of including the technical update in attrition year filings, the Commission did not include changes in plant mix in technical update. Therefore, we conclude that we contemplated no change from this treatment when we issued D.86-12-099, requiring a 1987 attrition year filing based on the interim results of operation adopted in D.86-01-026 (Pacific Bell's post divestiture 1986 test year general rate case).

Since Resolution T-12007 calculated the technical update for the 1987 attrition year consistent with that practice (i.e., without recognizing changes in plant mix), we believe it properly excluded the additional sums requested by Pacific Bell in Advice Letter 15215 from calculation of the technical update.

Pacific Bell's request to reduce its booked depreciation expense is inconsistent with the above disposition of the issues. Moreover, to the extent Pacific Bell seeks a general change in the

way it books its depreciation expense, its request is beyond the scope of this limited rehearing.

Because our disposition of the technical update issue does not recognize any shifts in plant mix, it does not recognize attrition year shifts in plant mix due to our authorizing Pacific Bell in D.85-08-047 to depreciate plant added to two plant categories¹⁷ beginning in 1986 using the ELG method, rather than the VG method. Pacific Bell made no argument in Advice Letter 15215 or in this limited rehearing proceeding that such shifts are the type of changes which should be recognized as "governmental or regulatory actions which have a definitely quantifiable effect on the attrition year revenue requirement" (D.86-12-099, Section M, mimeo. p. 25), although the ALJ requested late-filed Exhibit 8 in an attempt to augment the record on this question.

Moreover, Pacific Bell's Exhibit 8 ELG calculation of \$17.4 million is unacceptable as a Section "M" calculation. Exhibit 8 includes not only those changes in plant mix resulting directly from our authorization of ELG depreciation for the two plant categories involved, but also other differences between Pacific Bell's estimated 1987 plant mix and the plant mix adopted for Pacific Bell's 1986 test year relating to those two categories. As explained above, our practice is not to recognize changes in plant mix in technical update in attrition filings. Moreover, to recognize changes in plant mix in attrition years would certainly be inconsistent with our concern that plant additions be validated by a showing of reasonableness in general rate cases. Nonetheless, we do not wish to close the door to a "Section M-type" showing in future years, despite the fact that Pacific Bell has not raised this precise argument to date. Therefore, we are willing to

¹⁷ These two plant categories are Circuit-Other and COE-Electronic.

consider such a showing (as authorized by D.86-12-099) in connection with Pacific Bell's upcoming 1988 attrition year filing, due January 30, 1988 (D.87-10-075).

More specifically, in its 1988 attrition year filing, Pacific Bell is free to make a Section "M" showing that increased depreciation expense due to increased levels of ELG plant should be recognized, subject to the following limitation: Consistent with the above discussion, we will recognize no change in the percentages of Circuit-Other and COE-Electronic plant within Pacific Bell's adopted test year 1986 plant mix, but we will consider recognition of the impact of increased proportions of ELG plant within each of those categories due to: 1) authorized additions to those two plant categories;¹⁸ and 2) retirement of older plant subject to VG treatment in those two plant categories and its replacement with newer plant subject to ELG treatment.¹⁹ Plant categories subject to ELG treatment are to be capped at the same growth rate used for the attrition year telephone plant in service. Additions to plant are to be made in ELG plant, while retirements are to be made in VG plant. Pacific Bell should support any such request with a showing that recognition of D.85-08-047's impact meets the criteria set forth in Section "M" of D.86-12-099, and use a formula designed to capture only the above-noted limited impacts.

In sum, we have carefully considered all the issues and arguments raised in Pacific Bell's application for rehearing of Resolution T-12007, including those matters held in abeyance in

¹⁸ i.e., growth in those plant categories representing their proportional share of the attrition cookbook's formula for growth in telephone plant in service (TPIS).

¹⁹ Pacific Bell should rely on the kinds of plant retirement ratios it has used previously, as shown in Exhibit 2 (Attachment 3, stamped page 53985).

D.87-06-022 (Ordering Paragraph 5), and are of the opinion that sufficient grounds for granting rehearing have not been shown.

Findings of Fact

1. In D.86-07-022, we granted rehearing in this matter for the limited purposes of receiving evidence and argument concerning what properly should have been included within the "technical update of book depreciation rates" for attrition purposes as ordered by D.86-12-099, and determining whether any of the sums requested by Pacific Bell that Resolution T-12007 excluded from the Technical Update for Depreciation Expense should be allowed in calculating Pacific Bell's 1987 attrition revenue requirement.

2. D.86-07-022 excluded relitigation of prior Commission policy decisions from the issues specified for limited rehearing in connection with the technical update question and restricted the limited rehearing to consideration of whether Resolution T-12007 properly carried out D.86-12-099.

3. Pacific Bell presented evidence in support of its Advice Letter 15215 technical update calculations which focused on the need to recognize changes in plant mix (including associated ELG impacts) over and above adopted 1986 test year levels, in order to assure "full capital recovery".

4. DRA presented evidence in support of a "combined method" for calculating attrition year depreciation expense; under this method, Pacific Bell's 1987 attrition year revenue requirement would increase by approximately \$6.5 million, although DRA maintained that the revenue requirement adopted in Resolution T-12007 was also reasonable.

5. In Pacific Bell's 1984-1985 attrition filing (addressed in D.85-03-042) the incremental expense associated with technical update did not reflect any change in plant mix. D.85-03-042 calculated General's 1985 technical update using the adopted plant mix as a base. D.85-12-081 (December 18, 1985) likewise calculated

General's 1986 technical update using the adopted plant mix as a base.

6. Thus, the evidence adduced during this limited rehearing shows that while no definitive formula for calculating technical update has been specified by this Commission, the Commission's practice in the period immediately preceding issuance of D.86-12-099 (December 22, 1986) has been not to reflect any changes from the adopted plant mix in the incremental expense associated with technical update. To the extent, if any, the procedure used for Pacific Bell in D.84-06-111 differed, the difference was rooted in divestiture-overlay considerations.

7. In D.86-12-099, the Commission endorsed the inclusion of technical update in attrition filings, subsequent to issuance of its interim decision on Pacific Bell 1986 test year results of operations; thus, the "divestiture-overlay" was no longer a consideration.

8. Resolution T-12007's treatment of the technical update for attrition year 1987 followed the Commission's practice in the period immediately preceding issuance of D.86-12-099 and, therefore, properly did not reflect changes in plant mix in the incremental expense associated with technical update.

9. The attrition cookbook precludes recognition in the operations piece of changes in depreciation expense and the composite depreciation rate due to changes in plant mix.

10. Pacific Bell has not raised a Section "M" argument, and accordingly, we will not grant it any Section "M" relief for 1987. However, D.85-08-047's adoption of ELG treatment for two plant categories may be the type of governmental or regulatory action whose effects, to the limited extent specified in this order, may be recognized in future attrition year reviews.

Conclusions of Law

1. Given the defined scope of this limited rehearing, and the evidence presented, none of the arguments advanced by Pacific Bell or DRA warrant any increased revenue requirement calculations here. Pacific Bell's policy arguments about "full capital recovery" are not dispositive of the particular question here and DRA's combined method proposal is beyond the scope of this proceeding.

2. Pacific Bell's request for changes on rehearing of Resolution T-12007 should be denied.

3. In all other respects, Pacific Bell's application for rehearing should be denied.

ORDER

IT IS ORDERED that:

1. At the time Pacific Bell submits its 1988 attrition filing, pursuant to D.87-10-075, it may submit its proposal for recognition of the ELG impacts on depreciation for the 1988 attrition year, consistent with the preceding discussion. Thus, in any such proposal, plant categories subject to ELG treatment are to be capped at the same growth rate used for the attrition year telephone plant in service; and additions to plant are to be made in ELG plant, while retirements are to be made in VG plant. This filing shall be served on all parties of record in this proceeding and in A.85-01-034.

2. Pacific Bell's application for rehearing of Resolution T-12007 is denied.

This order is effective today.

Dated December 17, 1987, at San Francisco, California.

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

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



Victor Weisner, Executive Director