ALJ/MJG/jt (Mailed 3/25/88)

Decision 88 03 072 MAR 23 1988

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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

(See Decision 87-12-063 for appearances.)

SECOND INTERIM OPINION

Background

By Decision (D.) 87-12-063, to the extent provided in the order, the Federal Communications Commission (FCC) Part 32, Uniform System of Accounts for Telephone Companies (USOA) was adopted for all telephone utilities under the Commission's jurisdiction.

Part 32, the first major restructure of the USOA since 1935, provides the telephone companies flexibility to provide for changes in the present complex, competitive, technological, and economic environment. It is a financial-based accounting system which facilitates the monitoring of revenues, expenses, and investments by product, service, purpose and type; facilitates management reporting data for cost of service and the separations and settlements process; and accommodates generally accepted accounting principles (GAAP) to permit a closer alignment with business which is not regulated.

D.87-12-063 kept open this investigation to address the Financial Accounting Standards Board (FASB)[1] Statement No. 87 (Statement), Employers' Accounting for Pensions, and to receive balancing account reports as required by Ordering Paragraphs 5 and 6 of D.87-12-063. This interim order addresses only the Statement. The balancing account reports due on or before March 31, 1988 by the utilities implementing such account, and on or before May 2, 1988 by the Division of Ratepayer Advocates (DRA) and other interested parties, will be addressed after receipt of the reports.

Evidentiary hearings on the Statement were held on October 8 and 15, 1987. Testimony was received from approximately eight witnesses. Concurrent briefs were filed on October 30, 1987 by the DRA, AT&T Communications of California, Inc. (AT&T), Continental Telephone Company of California (ConTel), General Telephone Company of California (GenTel), and Pacific Bell.

Historical Pension Cost

Historically, the telephone utilities accounted for their pension costs through an aggregate cost method (ACM), or a cost approach, for financial statement and ratemaking purposes. Such a method projects the estimated total benefit at retirement; an amount calculated to provide such retirement benefit, discounted to the present, is spread on a levelized basis over future years.

FASB 87

The Statement, for financial statement purpose, requires a standardized accrual method for measuring net periodic pension cost based on the benefits received, a departure from the present cost method. It also requires expanded financial statement disclosures and immediate recognition of a pension liability when

1 The FASB issues statements which prescribe generally accepted accounting principles. Such statements are recognized by the accounting and financial community as the basis for financial reporting.

the accumulated benefit obligation exceeds the fair market value of the pension plan assets.

Under the method prescribed in the Statement, pension cost for a given year is set equal to:

a. The expected increase for that year in the projected benefit obligation under a unit credit method,[2] plus

b. Interest at the settlement rate on the projected benefit obligation at the beginning of the year, less

c. Interest at the expected long-term rate on the plan assets as of the beginning of the year, adjusted, and

d. By an amortization of unrecognized prior service cost, unrecognized gains or losses, and unrecognized transition obligations, if any.

Implementation for financial statement purposes is required of all companies, with certain exceptions, effective for fiscal years beginning after December 15, 1986.

Although the Statement is silent on the ratemaking treatment, a different statement, FASB 71, (as pointed out by Pacific Bell's witness Blackburn) does permit regulated utilities to continue using an ACM to calculate pension expense if the Commission continues to set utility rates using the ACM to calculate pension expenses.

As explained in the Statement and addressed by DRA and other witnesses, the FASB believes that the Statement continues the evolutionary search for more meaningful and more useful pension

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2 The unit credit method is based on the benefit that is expected to be paid to a retiring employee using a plan formula which is applied to years of service to date and salary at retirement.

accounting, and concludes that although the Statement is a worthwhile and significant step, its conclusions are not likely to be the final step in that evolution.

Impact

According to witnesses, adoption of the Statement for ratemaking purposes will reduce the amount of pension cost to be expensed in 1988. Although Roseville Telephone Company's pension expense is expected to increase approximately $35 thousand in 1988 Pacific Bell's, GenTel's, AT&T's, and ConTel's pension expense is expected to be reduced by approximately $10 million, $46 million, $6 million, and $2 million, respectively.

Interested Parties' Recommendations

The telephone utilities present opposing recommendations. AT&T and Pacific Bell recommend that the Statement not be used for ratemaking purposes. GenTel, ConTel, and several small independent telephone companies recommend full adoption.

DRA also recommends that the Statement be adopted. However, it proposes two modifications. These modifications, whose underlying rationales are discussed in a subsequent section of this opinion, relate to a ceiling of the maximum allowable Internal Revenue Service (IRS) tax deduction and a floor of the Employment Retirement Income Security Act (ERISA) contribution requirement computed using the unit credit method.

Discussion

The basic purpose of funding pension costs is to provide a financial discipline to the employer by requiring employers to dedicate funds currently for distribution to employees upon retirement, and to provide benefit security to employees by transferring such funds into a distinct fund to be used for the payment of employee pensions only.

At issue is the appropriate ratemaking treatment for the costs incurred by the telephone utilities to fund their employee pension funds. Prior to the establishment of the Statement, allowable ratemaking cost was premised on the ACM. This method, as discussed above, is based on the principle that an employee's estimated total retirement benefits at retirement should be spread evenly, or normalized, over the future work years of the employee.

Now, with the establishment of the Statement, a new method, the unit credit method, designated as the preferred method to account for pension cost by the FASB for financial statement purposes, based on the yearly pension costs of an employee, is being proposed for acceptable ratemaking treatment.

The proponents of using the Statement for ratemaking purposes argue that it is generally superior to the ACM because it provides a more rational and realistic method of accounting for pension costs. The more important reasons presented for ratemaking adoption are that (1) it is a GAAP, (2) it provides for the recognition of the yearly pension plan cost, and (3) it spreads pension cost more equitably across generations of ratepayers, mitigating volatility, and preventing the over-funding of pension costs.

<u>GAAP</u>

ConTel supports the adoption of the Statement for ratemaking purposes because it is GAAP, that is, a set of standards, concepts, and opinions recognized by the accounting and financial community as the basis for financial and Securities and Exchange Commission (SEC) reporting purposes.

This in itself does not demonstrate that the Statement is the more appropriate ratemaking treatment for pension cost. GAAP does recognize that regulatory treatment of certain costs may be different and does allow regulated industries to continue to recognize pension costs using the ACM method.

Even DRA recognizes that GAAP should not be determinative for ratemaking purposes. Its witness Wuehler testified that a basic theme prevailing in GAAP is one of conservatism from the investor's point of view. With this in mind, DRA made specific recommendations regarding GAAP changes incorporated in the FCC's USOA, one of which was not to adopt GAAP automatically. In D.87-12-063 we adopted DRA's recommendation that future GAAP changes not be adopted automatically for ratemaking purposes.

Recognition of Yearly Pension Plan Cost

DRA asserts that the arbitrary assignment of a "level" amount of pension costs to each year under the ACM is the principal reason why it believes that the Statement is superior to the ACM. According to DRA such cost assignment under the ACM improperly allocates pension costs because it does not assign pension costs to the years in which the employee earns the benefit. Rather, it assigns an equal amount of pension expense from year to year. DRA believes that ratepayers should be charged with no more and no less than the pension expense earned by the employee in a given year. It also believes that the Statement better approximates the cost of an employee's pension over that employee's service period.

In contrast, Pacific Bell asserts that DRA's allegation that the Statement is superior because it allocates pension costs according to when the pension benefit is earned by the employee is incorrect. In support, it cites DRA's failure to conduct a study to substantiate that pension plan terms reflect the earning of specific annual benefits by an employee or whether those terms reflect the total benefit the employer will provide to the employee upon retirement. Even if such studies were conducted and did substantiate DRA's claim, Pacific Bell maintains that it would merely show that employees earn a larger portion of their pension each year as they age.

Pacific Bell also asserts that employees are promised a benefit at retirement and that benefit at retirement is what the employee is earning, not an incremental increase in benefits as the employee's age increases. However, if the Statement is adopted, current ratepayers would pay varying amounts for pension expense for different employees, even though the benefit received from each employee may be identical, simply because one employee may be older than the other.

DRA's Kenney concedes that for a given employee the Statement method produces a greater revenue requirement in nominal dollars over the career of an employee than does the ACM. However, he argues that the cash flow required under the Statement is "back-loaded" towards the end of the employee's career and that, in the absence of an aging work force, the Statement can produce a stable, non-escalating pension cost.

Recognizing that the ERISA statutory minimum pension funding standards and the IRS maximum pension funding standards cannot be met under the Statement, DRA proposes to modify the Statement to incorporate a ceiling of the maximum IRS tax deductibility for pension contributions and a floor of the ERISA minimum contribution requirement computed using the unit cost method.

Pacific Bell points out that the Statement does not conform to ERISA or IRS requirements, therefore, the Statement cannot be used to calculate the actual funding for its qualified pension plans. If adopted, it would need to employ a different method for funding its pension plans and result in a mismatch of cost, either an over-funding or under-funding. This would be a departure from the traditional practice where the amount of pension funding should equal what was expensed for ratemaking purposes.

Although GenTel supports the Statement, its witness DeBonis testified that the imposition of any restrictions or rules beyond those identified in the Statement, such as DRA's proposed modifications discussed above, would eliminate internal consistencies in the Statement and render it unacceptable as a standard for accounting and ratemaking purposes. For example, an arbitrary shortening of any of the amortization periods provided in the Statement would significantly increase the volatility of the pension accrual, and result in an undue burden or benefit to ratepayers at a given point in time.

If any modifications to the Statement is imposed, GenTel would opt for the present ACM, thereby leaving only DRA in favor of the Statement.

Mitigation of Volatility

DRA recognizes that volatility in annual pension expenses and revenue requirements is a concern. Although it recognizes that the Statement places reliance on (1) current interest rates to calculate the projected benefit obligation, (2) the use of market value in the valuation of pension plan assets, and (3) use of accelerated cost amortization methods for prior service cost and unexpected gains and losses, it believes that volatility is controllable. According to DRA, this is supported by many "experts", although none of these experts testified in this investigation.

DRA also believes that volatility is mitigated because the FASB has incorporated numerous provisions into the Statement to help alleviate this problem and that there is a certain amount of volatility in the pension expense methods currently being used.

One of the provisions, or smoothing effects, available to mitigate volatility is the use of the interest component of the net periodic pension expense which need not be restricted to current prices of annuity contracts or short-term current interest rates. Other reliable sources, such as rates of return on high-quality fixed-income investments with durations that match the pension obligations, could be used.

Another provision for smoothing pension expense is the return on plan asset component. Although the Statement uses the actual return on plan assets as a component of net periodic pension expense, it is subsequently adjusted to the expected return based on the expected long-term rate of return on plan assets and the market-related value of plan assets, through a separate computation in the gain or loss component. Rather than measuring plan asset value using strict fair or market value, the Statement allows the use of an averaging approach which allows the plan assets to be valued by either fair value or a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years.

In summary, DRA does not believe that the volatility issue, in and of itself, precludes the adoption of the Statement for ratemaking purposes.

In contrast, Pacific Bell asserts that volatility is the single biggest concern regarding the potential use of the Statement for ratemaking. Its witnesses testified that pension expense under the Statement can undergo large swings from year to year because of changes in interest rates and from the performance of stock and bond markets. In support, Pacific Bell cites October 19, 1987, more commonly known as Black Monday, the day which the Dow Jones Industrial Average dropped 508 points, the largest single drop, both numerically and as a percentage, in its history. Pacific Bell does not believe that the smoothing effects inherent in the Statement are adequate to handle changes such as Black Monday.

<u>Pension Over-Funding</u>

DRA also prefers the Statement because of a transition credit which amortizes excess pension assets through lower net periodic pension expense in future years. According to DRA, this transition credit is an over-funding of the pension fund as measured by the difference between the fair market value of the pension fund's assets and the projected benefit obligation. Pacific Bell's transition asset as at January 1987 was approximately $795 million and GenTel's was approximately $490 million.

DRA asserts that the over-funding results from the financial market performance and the use of the ACM, which leads to accruals in excess of the pension liability.

Pacific Bell disputes DRA's over-funding allegation. It contends that the transition asset was meant to be a method for companies to change gradually from the ACM method to the unit cost method. The large transition amount results from comparing the two actuarial methods which are configured to distribute costs differently, that is, from one which distributes cost evenly over a period of time to one which assigns less cost in the earlier years and more cost in the later years. Pacific Bell also points out (and DRA concurs) that the existence of the so-called over-funding results in part from the skill of pension fund managers, and from the existence of strong stock and bond markets.

Conclusion

As discussed in this interim opinion, adoption of the Statement for ratemaking purposes will require the utilities to change their method of recovering pension expense from the traditional cost approach to a benefits approach. Proponents of the benefits approach believe that it should be adopted because it is a "superior" method over the cost approach.

Assuming that the benefits approach is a superior method, that, in itself, is not the proper basis to set ratemaking policy. Traditionally, utilities have been allowed to recover those operating expenses, including pension expense, which they have demonstrated to be "reasonable costs". From a technical standpoint, there may always be a "superior," or "better," method. The test for determining whether pension expense should be calculated using the cost approach or the benefits approach or whether both approaches are acceptable is whether reasonable costs will be derived. Therefore, we do not find the "technical superiority" argument to be determinative.

The evidence shows that Statement will initially result in lower pension cost, but with a greater revenue requirement over the long term. Only in the absence of an aging work force can the Statement produce a stable, non-escalating pension cost.

We concur with Pacific Bell that employees are promised a benefit at retirement and that benefit at retirement is what the employee is earning, not an incremental increase in benefits as the employee's age increases. Retirement benefits are an incentive to attract and retain qualified employees. The present cost method properly assigns an equal, or normalized, amount of pension expense from year to year and meets the test of reasonable cost.

If the yearly benefits approach were adopted for pension expense, it would be inconsistent with other ratemaking policies. For example, large periodic expenditures, as well as abnormal and unusual expenditures, are currently normalized over a period of years, and not restricted to the year of occurrence. Similarly depreciation expense is recovered over the expected life of the asset, even though the utility and ratepayers receive the most benefit from assets that are new, rather than ones that are aged and under repair.

The Statement, which does not meet ERISA funding requirements, will result in a mismatch of the amount expensed for ratemaking purposes and the amount actually required to be contributed to the pension funds. Since IRS requirements are applicable to the deductibility of pension expense for tax purposes only, it should not be considered a funding component. Even though GenTel asserts that its pension expense developed by the benefits approach should meet ERISA and IRS requirements, it opposes DRA's proposal that the Statement be modified to reflect ERISA and IRS requirement.

GenTel asserts that DRA's proposal runs contrary to the objectives of the Standard and will result in inconsistencies. We concur. If the Statement is adopted, the telephone utilities might be denied an opportunity to recover their full pension cost as required by ERISA and the IRS.

Volatility is present and can be controllable in both the cost approach and benefits approach. Whether it is controlled

depends on the reasonableness on the individual utility's assumptions. However, inherent in the benefits approach is a greater possibility that volatility may not be mitigated because of the unpredictabilty of the stock and bond markets coupled with the averaging of the fair market value of plan assets over a short period of time, not more than five years.

We are not convinced by DRA's assertion that the utilities' pension funds are over-funded because of the cost approach or because of the performance of the financial markets in the last few years. Utilities' pension funds are scrutinized in general rate proceedings by DRA and other interested parties. In those proceedings where a utility's pension expense has not met the test of reasonableness, such as in Pacific Bell's D.74917 of November 6, 1968, the Commission has made appropriate ratemaking adjustments. Although the financial markets have performed well in the past few years, unpredictable shifts such as Black Monday do occur. Such performances are considered within the various pension factors to arrive at the appropriate pension expense.

We concur with Pacific Bell that the Transition Credit provided in the Statement is not the result of over-funding. Rather, it results from the comparison of two different actuarial methods, a cost method and a benefits method, and is designed to smooth over the change from one actuarial method to another.

For the reasons discussed above pension expense should continue to be based on the ACM for ratemaking purposes. The Statement will not be adopted at this time.

However, as with any accounting convention, we recognize that future circumstances could warrant reconsideration of this decision as experience is gained under the Statement, as regulatory policies are reviewed, or as the Statement itself is amended.

Section 311 Comments

Pursuant to the Commission's Rules of Practice and Procedure, the administrative law judge's (ALJ) proposed decision on this matter was filed with the Docket Office on February 8, 1988, and mailed to all interested parties of record. Comments were received from GenTel on February 26, 1988 and from ConTel and DRA on February 29, 1988. Reply comments were received from Pacific Bell on March 7, 1988.

Rule 77.3 of the Commission's Rules of Practice and Procedure provides that comments to the ALJ's proposed decision shall focus on factual, legal or technical errors in the proposed decision and in citing such errors shall make specific references to the record.

Filed comments that did not comply with Rule 77.3 were not considered. However, to the extent that the comments and reply comment addressed factual, legal or technical errors they were considered. Clarification, of specific matters, to the extent adopted was included in the appropriate place of the decision.

By comment, DRA points out that the proposed opinion does not address how the telephone utilities should record pension expense for accounting purposes. Absent a clear statement in this opinion DRA believes that the accounting question will need to be resolved in other proceedings.

However, by reply brief, Pacific Bell points out that FASB 87 specifically notes that accounting for pension costs should reflect the ratemaking treatment, in compliance with FASB 71, Accounting for the Effects of Certain Types of Regulation.[3]

We concur with Pacific Bell. FASB 71, issued by the FASB in 1983, requires that the financial statements of rate-regulated enterprises reflect the economic effects of the ratemaking process. In those instances where another authoritative source, such as a

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3 For rate-regulated enterprises, FASB 71 requires that the difference between the net periodic pension cost and the amount of pension cost considered for ratemaking purposes be recognized as an asset or liability.

different FASB, provides for cost to be accounted for in a manner not reflecting the economic effects of the ratemaking process, FASB 71 is to be followed. Therefore, the telephone utilities should use the current ACM, subject to FASB 71, to record pension costs for accounting purposes.

Findings of Fact

1. This investigation was kept open to address the FASB 87, employers' accounting for pensions, and to receive balancing account reports as required by Ordering Paragraphs 5 and 6 of D.87-12-063.

2. Evidentiary hearings on the Statement were held on October 8 and 15, 1987.

3. Historically, the telephone utilities accounted for their pension cost through an ACM, or a cost approach, for financial statement and ratemaking purposes.

4. The Statement, for financial statement purpose, requires a standardized accrual method based on the benefits received.

5. Companies, with certain exceptions, are required to implement the Statement for financial statement purposes for fiscal years beginning after December 15, 1986.

6. The FASB permits regulated utilities to continue using the ACM to calculate pension expense if the Commission continues to set utility rates using the ACM to calculate pension expenses.

7. The Statement conclusions are not likely to be the final step in the FASB's evolutionary search for more meaningful and more useful pension accounting.

8. In the short term, pension cost will be reduced under the Statement method.

9. The Statement does not conform to ERISA or IRS requirements.

10. The ACM method is based on the principle that an employee's estimated total retirement benefits at retirement should be spread evenly over the work years of the employee.

11. The unit credit method is based on the principle that pension costs should reflect the yearly benefits earned from the employees.

12. A basic theme prevalent in developing GAAP is one of conservatism from the investor's point of view.

13. GAAP changes are not automatically adopted for ratemaking purposes.

14. For a given employee the Statement method produces a greater revenue requirement in nominal dollars over the career of an employee than does the ACM.

15. Stable, non-escalating pension cost can be attained under the Statement if the utility's work force, as a group, does not age.

16. The Statement method cannot be used to fund a utility's pension plan.

17. GenTel opts for the present ACM over the Statement if any modifications are made to the Statement for ratemaking purposes.

18. The Statement places reliance on current interest rates to calculate the projected benefit obligation, the use of market value in the valuation of pension plan assets, and use of accelerated cost amortization methods for prior service cost and unexpected gains and losses.

19. The FASB incorporated provisions into the Statement to mitigate and control the volatility of pension expense.

20. Pacific Bell does not believe that the provisions incorporated in the Statement to mitigate and control pension volatility are adequate to handle unpredictable shifts in the financial markets.

21. The Statement provides for the amortization of a transition credit, which is measured by the difference between the fair market value of the pension fund's assets and the projected benefit obligation.

22. The transition credit is a method for companies to gradually change from the ACM method to the unit cost method.

23. The transition credit results for the comparison of two different actuarial methods.

Conclusion of Law

The Financial Accounting Standards Board Statement No. 87, Employers' Accounting for Pensions, should not be utilized for ratemaking purposes.

SECOND INTERIM ORDER

IT IS ORDERED that:

1. The telephone utilities shall use the current aggregate cost method, or cost approach, which normalizes pension cost over the employee's service period for ratemaking and accounting purposes.

2. The Financial Accounting Standards Board Statement No. 87 (Statement), Employers' Accounting for Pensions, which employs the unit credit method, or benefits approach, shall not be used for ratemaking or accounting purposes at this time.

3. This investigation remains open for the receipt of balancing account reports as required by Ordering Paragraphs 5 and 6 of Decision 87-12-063.

This order is effective today.

Dated March 23, 1988, at San Francisco, California.

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

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

Victor Weisser, Executive Director

depends on the reasonableness on the individual utility's assumptions. However, inherent in the benefits approach is a greater possibility that volatility may not be mitigated because of the unpredictabilty of the stock and bond markets coupled with the averaging of the fair market value of plan assets over a short period of time, not more than five years.

We are not convinced by DRA's assertion that the utilities' pension funds are over-funded because of the cost approach or because of the performance of the financial markets in the last few years. Utilities' pension funds are scrutinized in general rate proceedings by DRA and other interested parties. In those proceedings where a utility's pension expense has not met the test of reasonableness, such as in Pacific Bell's D.74917 of November 6, 1968, the Commission has made appropriate ratemaking adjustments. Although the financial markets have performed well in the past few years, unpredictable shifts such as Black Monday do occur. Such performances are considered within the various pension factors to arrive at the appropriate pension expense.

We concur with Pacific Bell that the Transition Credit provided in the Statement is not the result of over-funding. Rather, it results from the comparison of two different actuarial methods, a cost method and a benefits method, and is designed to smooth over the change from one actuarial method to another.

For the reasons discussed above pension expense should continue to be based on the ACM for ratemaking purposes. The Statement will not be adopted at this time.

Findings of Fact

1. This investigation was kept open to address the FASB 87, employers' accounting for pensions, and to receive balancing account reports as required by Ordering Paragraphs 5 and 6 of D.87-12-063.

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We concur with Pacific Bell that the Transition Credit provided in the Statement is not the result of over-funding. Rather, it results from the comparison of two different actuarial methods, a cost method and a benefits method, and is designed to smooth over the change from one actuarial method to another.

For the reasons discussed above pension expense should continue to be based on the ACM for ratemaking purposes. The Statement will not be adopted at this time.

Section 311 Comments

Pursuant to the Commission's Rules of Practice and Procedure, the administrative law judge's (ALJ) proposed decision on this matter was filed with the Docket Office on February 8, 1988, and mailed to all interested parties of record. Comments were received from GenTel on February 26, 1988 and from ConTel and

3. Historically, the telephone utilities accounted for their pension cost through an ACM, or a cost approach, for financial statement and ratemaking purposes.

4. The Statement, for financial statement purpose, requires a standardized accrual method based on the benefits received.

5. Companies, with certain exceptions, are required to implement the Statement for financial statement purposes for fiscal years beginning after December 15, 1986.

6. The FASB permits regulated utilities to continue using the ACM to calculate pension expense if the Commission continues to set utility rates using the ACM to calculate pension expenses.

7. The Statement conclusions are not likely to be the final step in the FASB's evolutionary search for more meaningful and more useful pension accounting.

8. In the short term, pension cost will be reduced under the Statement method.

9. The Statement does not conform to ERISA or IRS requirements.

10. The ACM method is based on the principle that an employee's estimated total retirement benefits at retirement should be spread evenly over the work years of the employee.

11. The unit credit method is based on the principle that pension costs should reflect the yearly benefits received from the employees.

12. A basic theme prevalent in developing GAAP is one of conservatism from the investor's point of view.

13. GAAP changes are not automatically adopted for ratemaking purposes.

14. For a given employee the Statement method produces a greater revenue requirement in nominal dollars over the career of an employee than does the ACM.

DRA on February 29, 1988. Reply comments were received from Pacific Bell on March 7, 1988.

Rule 77.3 of the Commission's Rules of Practice and Procedure provides that comments to the ALJ's proposed decision shall focus on factual, legal or technical errors in the proposed decision and in citing such errors shall make specific references to the record.

Filed comments that did not comply with Rule 77.3 were not considered. However, to the extent that the comments and reply comment addressed factual, legal or technical errors they were considered. Clarification, of specific matters, to the extent adopted was included in the appropriate place of the decision.

By comment, DRA points out that the proposed opinion does not address how the telephone utilities should record pension expense for accounting purposes. Absent a clear statement in this opinion DRA believes that the accounting question will need to be resolved in other proceedings.

However, by reply brief, Pacific Bell points out that FASB 87 specifically notes that accounting for pension costs should reflect the ratemaking treatment, in compliance with FASB 71, Accounting for the Effects of Certain Types of Regulation.[3]

We concur with Pacific Bell. FASB 71, issued by the FASB in 1983, requires that the financial statements of rate-regulated enterprises reflect the economic effects of the ratemaking process. In those instances where another authoritative source, such as a different FASB, provides for cost to be accounted for in a manner not reflecting the economic effects of the ratemaking process, FASB 71 is to be followed. Therefore, the telephone utilities should

3 For rate-regulated enterprises, FASB 71 requires that the difference between the net periodic pension cost and the amount of pension cost considered for ratemaking purposes be recognized as an asset or liability.

15. Stable, non-escalating pension cost can be attained under the Statement if the utility's work force, as a group, does not age.

16. The Statement method cannot be used to fund a utility's pension plan.

17. GenTel opts for the present ACM over the Statement if any modifications are made to the Statement for ratemaking purposes.

18. The Statement places reliance on current interest rates to calculate the projected benefit obligation, the use of market value in the valuation of pension plan assets, and use of accelerated cost amortization methods for prior service cost and unexpected gains and losses.

19. The FASB incorporated provisions into the Statement to mitigate and control the volatility of pension expense.

20. Pacific Bell does not believe that the provisions incorporated in the Statement to mitigate and control pension volatility are adequate to handle changes such as Black Monday.

21. The Statement provides for the amortization of a transition credit, which is measured by the difference between the fair market value of the pension fund's assets and the projected benefit obligation.

22. The transition credit is a method for companies to gradually change from the ACM method to the unit cost method.

23. The transition credit results for the comparison of two different actuarial methods.

<u>Conclusion of Law</u>

The Financial Accounting Standards Board Statement No. 87, Employers' Accounting for Pensions, should not be utilized for ratemaking purposes.

use the current ACM, subject to FASB 71, to record pension costs for accounting purposes.

__Findings of Fact__

1. This investigation was kept open to address the FASB 87, employers' accounting for pensions, and to receive balancing account reports as required by Ordering Paragraphs 5 and 6 of D.87-12-063.

2. Evidentiary hearings on the Statement were held on October 8 and 15, 1987.

3. Historically, the telephone utilities accounted for their pension cost through an ACM, or a cost approach, for financial statement and ratemaking purposes.

4. The Statement, for financial statement purpose, requires a standardized accrual method based on the benefits received.

5. Companies, with certain exceptions, are required to implement the Statement for financial statement purposes for fiscal years beginning after December 15, 1986.

6. The FASB permits regulated utilities to continue using the ACM to calculate pension expense if the Commission continues to set utility rates using the ACM to calculate pension expenses.

7. The Statement conclusions are not likely to be the final step in the FASB's evolutionary search for more meaningful and more useful pension accounting.

8. In the short term, pension cost will be reduced under the Statement method.

9. The Statement does not conform to ERISA or IRS requirements.

10. The ACM method is based on the principle that an employee's estimated total retirement benefits at retirement should be spread evenly over the work years of the employee.

11. The unit credit method is based on the principle that pension costs should reflect the yearly benefits earned from the employees.

SECOND INTERIM ORDER

IT IS ORDERED that:

1. The telephone utilities shall use the current aggregate cost method, or cost approach, which normalizes pension cost over the employee's service period for ratemaking purposes.

2. The Financial Accounting Standards Board Statement No. 87 (Statement), Employers' Accounting for Pensions, which employs the unit credit method, or benefits approach, shall not be used for ratemaking purposes at this time.

3. This investigation remains open for the receipt of balancing account reports as required by Ordering Paragraphs 5 and 6 of Decision 87-12-063.

This order is effective today.

Dated __________________, at San Francisco, California.

12. A basic theme prevalent in developing GAAP is one of conservatism from the investor's point of view.

13. GAAP changes are not automatically adopted for ratemaking purposes.

14. For a given employee the Statement method produces a greater revenue requirement in nominal dollars over the career of an employee than does the ACM.

15. Stable, non-escalating pension cost can be attained under the Statement if the utility's work force, as a group, does not age.

16. The Statement method cannot be used to fund a utility's pension plan.

17. GenTel opts for the present ACM over the Statement if any modifications are made to the Statement for ratemaking purposes.

18. The Statement places reliance on current interest rates to calculate the projected benefit obligation, the use of market value in the valuation of pension plan assets, and use of accelerated cost amortization methods for prior service cost and unexpected gains and losses.

19. The FASB incorporated provisions into the Statement to mitigate and control the volatility of pension expense.

20. Pacific Bell does not believe that the provisions incorporated in the Statement to mitigate and control pension volatility are adequate to handle unpredictable shifts in the financial markets.

21. The Statement provides for the amortization of a transition credit, which is measured by the difference between the fair market value of the pension fund's assets and the projected benefit obligation.

22. The transition credit is a method for companies to gradually change from the ACM method to the unit cost method.

23. The transition credit results for the comparison of two different actuarial methods.

<u>Conclusion of Law</u>

The Financial Accounting Standards Board Statement No. 87, Employers' Accounting for Pensions, should not be utilized for ratemaking purposes.

SECOND INTERIM ORDER

IT IS ORDERED that:

1. The telephone utilities shall use the current aggregate cost method, or cost approach, which normalizes pension cost over the employee's service period for ratemaking and accounting purposes.

2. The Financial Accounting Standards Board Statement No. 87 (Statement), Employers' Accounting for Pensions, which employs the unit credit method, or benefits approach, shall not be used for ratemaking or accounting purposes at this time.

3. This investigation remains open for the receipt of balancing account reports as required by Ordering Paragraphs 5 and 6 of Decision 87-12-063.

This order is effective today.

Dated MAR 23 1988, at San Francisco, California.

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